C.D. Howe Institute

Summary

Nikka Kankei:
Japanese-Canadian Relations, The Opportunities Ahead

H. Anthony Hampson

The Time for Action

The Canada-U.S. Free Trade Agreement has given Canadians still another chance to exercise their powerful obsession with their huge, energetic, and creative neighbor to the south. Yet despite the especially prominent place the United States has occupied recently in this country's economic affairs, Canadians' attention has also been caught at last by the emergence of Japan as the world's leading capital exporter and potentially the most powerful economy on this planet by early next century.

Japan is Canada's second largest customer, although exports to that country in 1987 were only C$7 billion compared with the C$91.8 billion we sold to the United States. Canada ranks only eighth in importance as a supplier of imports to Japan, and while Japanese interest in Canada is growing, it is still relatively low. Their attention, too, is focused on the

United States: to most Japanese, Canada is the unimportant part of North America.

Canada's unique personality has flourished in spite of its increasingly closer relationships with the United States; however, it still worries that it will attract too much attention from its southern neighbor. In contrast, Japan's greatest concern has been that it will lose the attention of the United States and become economically isolated in a hostile and protectionist world.

Although both Canada and Japan tend to neglect each other to focus on the United States, they do share major common interests. No two countries have more at stake in an open trading world or in the market system, for Japan's economic success — contrary to widespread belief — has been based on astute private-sector management, on spotting market opportunities early, and on adopting a highly competitive, high-quality, high-value response to them. Both countries also have a shared interest in the development of an adaptable society based on information, communications, and technology, the key elements to sustainable growth in the future. And no two countries are more dependent than Canada and Japan on the success of international economic cooperation in macroeconomic policy and tariff reductions.

Both countries have much to learn from each other: Japan in promoting variety, expanding its social capital, and understanding the social and political dynamics that drive the U.S. market; Canada in accepting the discipline of the marketplace in order to promote needed change and the competitiveness on which living standards ultimately depend. Canadians, too, could certainly learn something about the gains to be had from working cooperatively to solve problems.

Why Now Is an Opportune Moment

There has never been a better opportunity than the present to improve relations between Canada and Japan.

Japan's heightened awareness in 1987 of the risk of being economically isolated and of the dangers of relying so heavily on exports as the principal engine of growth have given it a more outward-looking and international perspective in which Canada is seen by a small but growing number of Japanese as a potential friend and ally.

This Japanese interest in Canada was stimulated by the Kanao Report, the result of a Japanese economic mission to Canada in the fall of 1986 that was highly complimentary to Canada and its prospects. This report made a worthwhile beginning in shifting Japan's perspective from Canada's resource industries to its high-growth, high-technology manufacturing industries.

The most powerful factor, however, in increasing Japanese awareness of Canada has been the Free Trade Agreement with the United States. While many Japanese jumped rather quickly to the view that this was another inward-looking and protectionist move, others have seen it for what it is: a move by two of the world's greatest proponents of freer trade to show other countries that protectionism is not the only alternative.

In this latter view, Canada can now be a friend of Japan inside the U.S. gate. The Free Trade Agreement will make that friend a stronger competitor, particularly for manufactured products, as secure access to the large U.S. market will provide Canadian firms with longer production runs and lower costs. But the Agreement's most significant impact will be an intangible one — to enlarge the export ambitions and enhance the confidence of Canadian manufacturers.

Canada, as a friend of both Japan and the United States, is well placed to mediate some of the difficulties these two countries have had with one another. All three countries have a strong interest in an open economic system in which trade, investment, and ideas can flow freely, change is encouraged, and needed adjustments can take place easily.

Both Canada and Japan are highly dependent on continued access to technology and products originating in the United States, which is still by far the world's most dynamic, original, and innovative economy. This "golden wind" of discovery, innovation, and product development from the United States is as vital to the prospects of the Japanese and Canadian economies as the staving off of protectionist pressures.

Getting the Macroeconomic Setting Right

No single economic factor is more important for Canada and its relationships with Japan than getting the global macroeconomic environment right. Canada, however, has little influence on how the world's major economic levers are set. That is primarily determined by Japan and the United States.

In the spring of 1987, Japan, having realized that unbalanced reliance on exports would only be self-defeating in leading to a higher yen and strong protectionist reactions abroad, began a program to encourage more vigorous domestic demand, accompanied by a substantial expansion of imports and the opening up of the Japanese economy. A U.S.$42 billion program for expansion of public works and housing, as well as tax cuts, probably contributed 1 percent to Japanese real growth of 4.2 percent in 1987. More of the burden of continuing this growth in 1988 will fall on consumption expenditures, buoyed by a further tax cut.

These demand measures were supported by other government steps to restructure the economy — deregulation, dismantling of trade restrictions, increased foreign purchases by public agencies, and steps to modernize the backward sectors of the economy.

The main factor in Japan's capacity to resume rapid growth in the face of a dramatic currency change, equivalent to the rise of the Canadian dollar to U.S.$1.40, is the amazing

adaptability of the private sector. Japanese culture does not encourage people to persist for long in actions or behavior that are clearly mistaken, wrong, or simply inferior to another in producing results. Successful market-oriented responses reflect this willingness of its society to adapt to new realities.

As a result, Japan's trade surplus in dollar terms is now falling, catching up with an earlier improvement in both yen and volume terms. More importantly, Japanese imports are rising sharply, having increased 45 percent in volume since the Plaza Accord in late 1985. Manufactured goods now account for almost half of Japanese imports, virtually double the percentage of only three years earlier. These imports reflect increased sourcing in the United States and Canada as well as in other Pacific Rim countries.

It is not inconceivable that some U.S.$50 billion of Japan's 1987 trade surplus of U.S.$96 billion could disappear by 1990, with an improvement of some U.S.$20 billion attainable in 1988.

With the Japanese side of the adjustment process now working satisfactorily, there is concern that the United States will not take the actions needed to curtail its private and public consumption, raise its savings rates, and increase its competitiveness. This view, however, ignores the steps the United States has already taken to reduce its government deficit and underestimates the power of a new president to take needed action. It also does not take fully into account the responses occurring in the private sector of the U.S. economy. U.S. manufacturing still accounts for the same proportion of GNP that it did 30 years ago, and its overall productivity is still the world's highest in absolute terms. Moreover, that productivity has grown sharply — at 4.8 percent annually from 1982 to 1987, double the rate of the previous 20 years — partly because of intense competition, but also because of a big increase in physical investment and in research and

development. Gross investment has been at an all-time high of over 11 percent of GNP.

U.S. export volumes rose by 44 percent from the beginning of 1986 to the middle of 1988, while U.S. imports actually declined slightly in the second quarter of 1988. The United States' trade balance has been improving for some time in volume terms, although only recently in dollar terms. An improvement of up to U.S.$50 billion is possible in 1988, so that the trade deficit could be running at an annual rate of under U.S.$100 billion by year-end.

On both the U.S. and Japanese sides of this vital bilateral relationship, the prospects are relatively good. Thus, the background for enhanced flows of trade, investment, and technology between Canada and Japan is a good deal more favorable than one would have dared to hope even in early 1987.

Restructuring an Expanding Japanese Economy

Powerful, trade-promoting forces are now at work in Japan to weaken the governmental, cultural, and private non-tariff barriers that have impeded the growth of Canadian exports to that country, particularly in manufactured form. This dismantling is proceeding in an admittedly Japanese way — and too slowly. Canadian exporters thus continue to face barriers, particularly those that protect agriculture and the smaller, inefficient enterprises that act as shock absorbers for the more competitive and technologically advanced sectors of the Japanese economy.

In agriculture, where Japanese consumer prices for rice can be six times those in the United States, the combined influence of greater consumer awareness and the change in the balance of political power toward the urban "salary man" is beginning, very gradually, to diminish the farmers' power. The breaking down of trade barriers in this sector, which was un-

thinkable only a few years ago, has considerably brightened the outlook for exports of Canadian agricultural and food products to Japan.

Consumption of housing, and thus of imports of building materials such as Canadian lumber, is restricted by land shortages, import barriers, regulations, and a weak social capital structure. Tax and other changes are just beginning to ease the land shortage, but Japan must do more to increase its housing stock.

The labyrinthine Japanese distribution system is one of the factors that causes the Japanese consumer to suffer from high prices. Competition, however, is at last beginning to be felt in this sector too, partly as a result of increasing foreign travel by the Japanese. Nevertheless, the system still acts as a barrier to more Canadian exports, especially of consumer goods.

Some of the more domestically oriented departments of the Japanese government are openly protectionist despite the pressure put on them by the more internationalist ministries such as Finance, Foreign Affairs, and International Trade and Industry. The protection-promoting links between industry and the civil service result in part from the lack of firm political control of public servants, a situation that is now beginning to change.

In summary, forces are at work to weaken or eliminate many Japanese nontariff restrictions, and those remaining can usually be overcome with patience and persistence.

Tax reform, particularly changes in taxes applying to savings, has reinforced the long-term tendency for the Japanese savings rate to fall. This has led to a trend toward higher consumption rates and increased imports, a trend that is further augmented by the aging of the Japanese population.

The restructuring of the Japanese economy has also tended to be import promoting. Further automation, careful attention to costs, and focus on high-growth products have

been accompanied by an increasing proportion of production being sourced abroad. For instance, over half of Japan's cameras are now imported, and the proportion of Japanese manufacturers' output sourced externally will rise from a range of 3–5 percent today to 10–15 percent in a very few years.

Japanese unit costs have actually fallen in yen terms — aided by the cost flexibility of early retirements, transfers to associated companies, and the creation of new companies in which to place laid-off workers. The Japanese system of labor adjustment is made easier by the existence of enterprise unions, a system of pay by seniority, and a tradition of lifetime employment in the bigger companies. However, these features do not apply to smaller companies or to part-time, contract, and temporary workers.

As a result of these smooth adjustments, unemployment in Japan has actually fallen while profits in manufacturing have risen sharply — by 66 percent in the fiscal year ending March 31, 1988.

Prospects for Trade, Investment, and Technology Exchanges

The strong Japanese economy, its slow restructuring, and the gradual weakening of trade barriers provide a favorable background for more trade, investment flows, and technology exchanges between Canada and Japan.

Canada is the only Group-of-Seven country currently running a trade surplus with Japan. Canadian exports to Japan traditionally have consisted of relatively unprocessed resource products, although manufactured exports are increasing in importance. Canada has not made as many inroads in Japan as have other countries, however, partly because of the pull of the bigger, closer, and easier U.S. market and partly because Canadian exporters have not put in the

sustained efforts to build relationships of trust and mutual interest that are crucial to success in Japan. Such relationships are not easily made, but neither are they easily broken.

Traditional Japanese exports to Canada, such as office equipment and electronics, will continue to reflect Canada's economic growth, although overcapacity in the North American automobile industry may keep the growth of Japanese auto exports below historic rates. While so-called voluntary restraint arrangements are not now limiting imports, Canada and Japan should agree to remove them as they have been very costly to consumers and ineffective in stimulating domestic employment.

Canadian exports to Japan are expected to grow rapidly and to shift in composition, reflecting both Japanese growth and the rising interest of Japanese consumers in foreign goods. For Canadians, the opportunities are wide ranging — from processed foods to high-technology items such as telecommunications equipment. The longer runs that Canadian manufacturers will obtain as a result of access to the U.S. market will reduce the costs and increase the competitiveness of Canadian manufactured goods. This should mean that more of Canada's exports to Japan will be in processed form. Exports of services — including consulting, software, those related to the teaching of English, and tourism — should be vigorous.

Japanese investment in Canada is considerable — C$36 billion at the end of 1986 — but is largely in the form of government bonds and loans. Growing awareness and expertise about Canada has led to some increase of Japanese holdings of good-quality Canadian corporate bonds and even a few blue chip stocks. Japanese direct investment in Canada, however, is still relatively small, amounting to $2.5 billion at the end of 1987. The inflow in that year was approximately $300 million, largely for investments in auto plants and parts facilities.

Only a few joint ventures between Canadians and Japanese in high-technology products and systems are now taking place.

There is a great potential for Japanese and Canadian firms to work together on research and development, on technological and product improvements, and on the transfer of existing technology from one country to another. Wider use of joint ventures, however, will require more open and cooperative attitudes on both sides than has been the case in the past.

Canada's strengths in biotechnology, medicine, polymers, remote sensing, software, and telecommunications — to name just a few areas — suggest some of the possibilities for joint licensing and/or technological ventures. Beyond these possible commercial links, Canadian universities, with their increasingly outward-looking attitudes, ought to offer excellent value to their Japanese counterparts.

In summary, Canada has many opportunities to expand its links with Japan in trade, especially in manufactured goods; in investments in Canada — particularly those designed to serve the U.S. market as well — where Canadian familiarity with U.S. customers can be a major advantage; and in technology, where Japan's production and product commercialization skills can be combined with Canada's growing abilities in technology, innovation, and the information-intensive industries.

Prospects, Policies, and Conclusions

To take full advantage of the favorable potential for Canadian-Japanese relations, the Canadian private sector needs to be more aggressive in building relationships with Japan and in explaining how the investment climate has changed since 1984. There also needs to be more stress on the growth and potential of Canada's technologically and infor-

mation-intensive industries, which the Canada-U.S. Free Trade Agreement will further accelerate.

It is critical that both the private and public sectors avoid unconstructive "Japan-bashing," despite Japanese protectionist abuses. Nevertheless, the arguments against such protectionism must be forcefully and reasonably presented, since any lack of determination in negotiating with the Japanese is a sure way to lose the argument. The right strategy is to be polite in public and tough in private. Japan also needs to be reminded that, as one of the world's leading and richest powers, it has a special responsibility not to take shortsighted measures that jeopardize global economic stability.

Both countries are playing their part in promoting economic growth and sensible, balanced international cooperation. Canada needs to reduce its fiscal deficits further, however, if it is to avoid a possible major fiscal crisis. For its part, Japan now recognizes the importance of keeping its macroeconomic policy correctly focused, and it is unlikely to pursue the shortsighted and illusory policies it followed before 1986. Japan increasingly realizes that, if the world is to prosper, it must play an important part in creating that prosperity.

Canada must encourage Japan to play this leadership role and find the right balance between diffidence and assertiveness. This is particularly true in its efforts to influence U.S. macroeconomic policy to bring about better balance between that country's consumption and investment. The rapid growth of Canadian and Japanese sales to the United States will not continue at the pace of recent years, but both countries will still share the privilege of being closely tied to the world's largest and most innovative economy.

Microeconomic Measure Are Crucial

It is also important for the two countries to continue to get their microeconomic policy settings right. Canada can learn much from Japan about the importance of farsighted management; eliminating barriers to change throughout society; diffusing new technology to small and medium-sized firms; encouraging high levels of saving; and promoting cooperation between all sectors of society, particularly between management and labor. Canada eventually will have to stop bailing out its failing industries and preserving them in a museum of the uncompetitive if it is to compete successfully in Japan and other markets.

Japan's microeconomic policies to promote growth must include tax reform, privatization, and deregulation; the promotion of innovation and variety; the stimulation of industrial flexibility; and the encouragement of a culture in which fresh ideas are valued and there is improved understanding of foreign customs and languages, especially English. Japan will have to overhaul its already changing distribution system and sharply reduce the remaining resistance in the bureaucracy to political control and to the forces of change. At the same time, the tone of political life in Japan will have to be raised to a level that befits that of a world leader.

These changes should be carried out in a way that does not undermine the very qualities that have made Japan a success — industriousness, cooperation, savings, interest in research and development, and a capacity for problem solving and for improving technology and production techniques. While more of its savings must be set aside to provide for social capital and for its own aging population, Japan increasingly must turn its eyes, its savings, and its talents outward to trade and to the international diffusion of technology. In short, it must achieve a better balance between domestic and foreign interests in the years ahead.

By showing that two rather different societies with different endowments and heritages can benefit from closer and more open trade and other links, Canada and Japan can encourage the rest of the world to pursue more liberal trade policies and to reduce the forces of protectionism.

Free Trade in the Pacific?

One way of ensuring a more favorable environment in which the Canada-Japan bilateral relationship could flourish, while moving the world toward freer trade multilaterally, would be to promote a free trade area in the Pacific. Ultimately, this would include Australasia and those of the region's newly industrializing economies that were prepared to join. Initially, however, it might encompass just the United States, Japan, and Canada. Alternatively, Canada and the United States might first broaden their own trade pact to include Australia and New Zealand, two market-oriented countries which now have their own free trade arrangement.

A Pacific Free Trade Area, in addition to making the countries involved even more dynamic, competitive, and innovative, could provide a useful hedge against the possible failure of the Uruguay Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), and put additional pressure on those negotiating at the GATT to reduce trade barriers multilaterally. It might also put pressure on the sclerotic economies of the European Community to ensure that their plan to become a true common market by 1992 is an outward-looking, nonprotectionist, and modernizing arrangement.

No one should underestimate the difficulty of creating a free trade area between the United States, Canada, and Japan. Knotty issues would have to be overcome, including social and cultural differences; nontariff barriers; and questions of defense production, subsidies, agriculture, government

procurement, and intellectual and investment flows. However, the lessons of both the Canada-U.S. and Australia-New Zealand deals are that determined and persistent negotiations can lead to worthwhile arrangements and that not every issue must be resolved immediately. The process will be a long one — likely over five years — and it would be wise to get started now.

There is growing support for the idea, despite the inevitable political difficulties and the tricky problem of resolving how the deal would affect the newly industrializing countries of the Pacific Rim. Japan, with its special relationship to those countries, would have to satisfy them that a free trade deal either included them or compensated them — perhaps by Japan's offering them enough of its own domestic market to offset any loss of competitiveness they might suffer in U.S. markets as a result of Japan's enhanced position there.

As governments and private institutions on both sides of the Pacific begin to look at the idea, Canada might draw on its own experience with the United States to bring about this wider Pacific agreement. In the case of the Canada-U.S. pact, when the situation was not yet ripe for formal talks the ground was prepared and the issues analyzed by a Royal Commission and a seminal analysis by the C.D. Howe Institute (Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation 27 [Toronto: C.D. Howe Institute, 1985]). Possibly, a distinguished commission of Americans, Japanese, and Canadians might do similar groundwork by producing a report analyzing the issues involved in a Pacific arrangement.

Such an arrangement, in addition to being a hedge against world relapse into protectionism, could lead to a leapfrogging of some of the special difficulties that bedevil relations between the United States and Japan. A fresh approach to antidumping problems, similar to the unique dispute settlement mechanism pioneered by the Canada-U.S. Agreement for ex-

ample, could make the exercise worthwhile. So too could mechanisms designed to defuse potential hostility toward Japanese investment in the United States. Moreover, as the two countries at the forefront of revolutions in information and communications, Japan and the United States need to apply policy creativity to solving the problems of rapid change that these revolutions are causing.

Canada has a particular interest in any United States-Japan arrangement; if it were excluded, its position in the fast-growing Japanese and related Pacific markets would be damaged and its prospects in the U.S. market would be dimmed by more competitive Japanese imports. Canadian participation in such a deal would also promote Canada's wider goals by encouraging the partners to look outward and to keep the ultimate objective of a multilateral arrangement very much to the fore.

A Pacific arrangement, in which Canada might play a special role as facilitator and mediator, would also improve political cooperation between the world's two major economic powers and make it easier for Japan to assume its growing responsibilities for world leadership, particularly in economic matters. Japan is likely to have to share that leadership and power with the United States, however, in some new form of cooperative, virtually condominium, arrangement.

The Enormous Potential Ahead

Japan once again has proven its enormous capacity to adjust to change. It has reoriented its economy toward domestic-led growth; it has begun to restructure its problem sectors; and it is opening up its society to the international flow of ideas, investment, and trade. Too many barriers to trade still remain, as do too many shortsighted policies that do grave harm to Japan's longer-term credibility — although these are beginning to change.

Japan's rapid growth will create many opportunities for Canada, particularly if Canada capitalizes on its new-found confidence and greater interest in exports. Not only should the percentage of Canada's foreign commerce conducted with Japan increase, but there is also enormous potential for investment and for joint ventures that promote the two-way spread of innovation. While resources, especially in processed form, will remain important, an increasing proportion of Canadian exports to Japan will involve goods and services that are knowledge-intensive.

Whether inside a wider Pacific arrangement or not, Canada can be a valuable friend to Japan, as well as an advisor and mediator in the U.S.-Japanese relationship. Although the first responsibility of Canada and Japan is to have sensible, domestic economic policies, together they can use their influence to ensure that world macroeconomic policy is also sensible and balanced.

In a zero-inflation world, to which the increasing role of the rapidly growing, highly productive Pacific Rim economies may lead, matters of microeconomic management and competitiveness take on increasing importance. If Canadians match their increasingly outward-looking perspective and undoubted economic capacities with a growing sense of discipline and competitiveness, this country's relationships with Japan and other Pacific Rim countries should be the source of even more vigorous growth, diversity, and wealth for Canadian society in the years ahead.

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H. Anthony Hampson

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The C.D. Howe Institute is an independent, nonprofit, research and educational institution. Its goals are to identify current and emerging economic and social policy issues facing Canadians; to analyze options for public- and private-sector responses; to recommend, where appropriate, particular policy options that, in the Institute's view, best serve the national interest; and to communicate the conclusions of its research to a domestic and international audience in a clear, nonpartisan way.

While its focus is national and international, the Institute recognizes that each of Canada's regions may have a particular perspective on policy issues and different concepts of what should be national priorities.

The Institute was created in 1973 by a merger of the Private Planning Association of Canada (PPAC) and the C.D. Howe Memorial Foundation. The PPAC, formed in 1958 by business and labor leaders, undertook research and educational activities on economic policy issues. The Foundation was created in 1961 to memorialize the late Rt. Hon. Clarence Decatur Howe, who served Canada as Minister of Trade and Commerce, among other elected capacities, between 1935 and 1957. The Foundation became a separate entity in 1981, and it continues to provide funding to the Institute.

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Foreword

In view of the growing importance and potential of Japanese-Canadian relations (*Nikka Kankei* in Japanese), the C.D. Howe Institute decided to commission this *Observation*, which is intended to heighten Canadians' awareness of the opportunities for expanding and deepening Canada's economic relations with Japan.

Japan has quickly become Canada's second-largest trading partner (after the United States) and, in recent years, has become a substantial investor in Canada. These facts alone merit increased attention to and analysis of Canada's economic relations with Japan. But it is the potential for expansion of this relationship, rather than its current importance, that makes this study so timely.

The author, H. Anthony Hampson, is Chairman of the C.D. Howe Institute Policy Analysis Committee and former President and Chief Executive Officer of the Canada Development Corporation. He has traveled extensively in Japan and has had many discussions with Canadian and Japanese experts from business, government, and academia on economic relations between the two countries.

The Institute gratefully acknowledges financial assistance from the Asia Pacific Foundation of Canada for this study. The manuscript was prepared by Brenda Palmer and Cordelia Sharpe and edited for publication by Barry Norris. As with all Institute publication, the conclusions are those of the author and do not necessarily represent the views of the Institute's members or directors.

The Institute intends to launch a research program on the policy and economic implications of more extensive links between Canada and its Pacific Rim neighbors, including Japan. The program will focus mainly on economic issues, but will keep global political and strategic considerations in mind as well. It will consist of studies and research undertaken by

scholars and experts in Canada and other Pacific Rim countries; seminars; and exchanges of scholars.

Through the publication of *C.D. Howe Institute Commentaries*, *Observations*, and major studies, as well as through meetings and conferences, the Institute hopes to increase public awareness, information, and interest about these important issues. In turn, this should encourage decisionmakers in Japan and Canada — and, importantly, in the United States — to adopt wiser and more effective public policies that lead to greater and more stable economic growth and, thus, to a richer and more diversified community of nations.

Maureen Farrow
President

Preface

My serious interest in the economy of Japan — and the political, social, and cultural forces which drive it — goes back a good 25 years. It certainly antedates the 1964 Tokyo Olympic Games, which in some ways marked the beginning of Japan's re-emergence as a serious player on the world's stage. (Those interested in parallels could easily draw them between the Japan of those days and the South Korea of today.)

Business, family, and other claims kept me from pursuing this interest, although I encountered increasing evidence of the Japanese as customers, competitors, and, occasionally, as partners in the intervening years. My fascination with the factors behind Japan's success led me to decide in 1985 that I would devote a portion of my new career to studying this subject. In this, I was encouraged by my wife, Wendy Dobson — at that time president of the C.D. Howe Institute — who was herself in the midst of preparing a book on Canada's position in the Japan-United States-Canada triangle.[1]

Accordingly, one of the first things I did on embarking on that career at the end of May 1987 was to go to Japan again and meet officials of government, research institutes, think tanks, and the private sector. Further study, visits, and analysis convinced me that there is a great need for Canada and Japan to get to know each other better; to work and trade together; and jointly to try to develop imaginative policy initiatives aimed at solving some of the world's economic difficulties. The commissioning of independent work on a Pacific Free Trade Area, or at least on its more modest possible beginnings as some sort of Pacific arrangement, is an example of how the two countries might start this process.

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[1]Wendy Dobson, ed., *Canadian-Japanese Economic Relations in a Triangular Perspective*, Observation 30 (Toronto: C.D. Howe Institute, 1987).

This *Observation*, then, is not designed to give either Japanese or Canadians an in-depth understanding of the psyche of the other — in any case, an impossible and ever-changing task. Instead, it is dedicated to increasing understanding of why now is a uniquely favorable time in the history of both countries to extend their relationships with each other. The study has a number of other objectives as well. First, it investigates the macroeconomic setting facing the two economies. Second, it outlines some of the possibilities for increasing investment, joint ventures, technological exchanges, and trade between the two countries. Finally, it draws some lessons from what has happened, and what will happen, to the relationship between Canada and Japan, especially in the context of each country's vital relationship with the United States. Canadians and Japanese, in fact, have enormous amounts to learn from the other. In the complex global setting in which both countries must operate, it is urgent that they absorb at least some of those lessons.

Too many people contributed to this *Observation* to thank them all personally. Among these are Japanese businessmen in Canada and Japan; the Ambassador and staff of the Canadian Embassy in Tokyo; Japanese research institutes, think tanks, and distinguished individuals such as Saburo Okita and Haruo Mayekawa; government departments and agencies in Tokyo, and Japanese diplomats in Europe, Asia, and North America; and the professional editing and administrative staff of the C.D. Howe Institute. I would, however, like especially to thank Ted English, Professor of Economics at Carleton University, and Ted Carmichael, Vice-President of the Institute, for their many thoughtful and constructive suggestions for improving this manuscript. While the help of all these people was enormous, the ultimate responsibility for this *Observation* and its conclusions must rest on my shoulders alone.

H.A. Hampson
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September 1988

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The Time for Action

The Canada-U.S. Free Trade Agreement has given Canadians still another chance to exercise their powerful obsession with their huge, energetic, and creative neighbor to the south. The United States has recently occupied an especially prominent place in this country's economic affairs. Yet Canadians' attention has also been caught at last by the emergence of Japan as the world's leading capital exporter, a major manufacturer of high-quality, value-added products, and potentially the most powerful economy on this planet by early next century.

A growing number of Canadians recognize that Japan is our second-largest customer — although Canada's exports to Japan in 1987 were only C$7.0 billion, compared with the C$91.8 billion sold to the United States. Fewer are aware that Canada ranks eighth in importance as a supplier of imports to Japan — behind Australia's smaller and more distant economy. Fewer still know that Japanese investment in Canada has been rising rapidly — although it is largely confined to government bonds; and hardly anyone is conscious of the enormous potential for joint ventures, licensing agreements, and cooperative research and development efforts between the two countries.

Japanese interest in Canada is also growing, but, not surprisingly, it is still relatively low. Canada is a much smaller country, with a Gross National Product just one-fifth of Japan's. When the Japanese think of North America they think almost exclusively of the United States, their most important economic and political partner and the principal source of Japan's defense. The major difficulties in Japan's trade, investment, or economic relations with the United States absorb almost all of their attention. To most Japanese, Canada

is the unimportant part of North America, and they see the majority of problems between the two countries as an almost inevitable by-product of their problems with the Americans. For Japan, too, is obsessed by its business, financial, and policy relationships with the United States, although its rapidly expanding relations with other Pacific Rim countries — especially China, Hong Kong, South Korea, Singapore, Taiwan, and Thailand — increasingly preoccupy Japanese businessmen and policymakers.

Canada's great fear has always been that Canadian culture and identity could not survive the (increased) attentions of its southern neighbor. In fact, Canada's unique personality has flourished despite the closer relationships of the two countries. In contrast, Japan's greatest worry has been that it will lose the attention of the United States and become economically isolated in a hostile and protectionist world. A narrow but growing band of nationalists aside, most economically literate Japanese recognize that continuing access to U.S. markets, ideas, and technology depends not only on mutually beneficial business logic, but also on the active friendship of Americans. Indeed, the links and the understanding between Japan and the United States are becoming both wider and more intimate despite the problems between the two countries.

Japan also needs the political security and stability that comes from its alliance with the globe's greatest economic power. U.S. support takes on extra importance in a world that resents Japanese competitiveness and productive efficiency, and that often fails to understand Japan and its culture. Indeed, the world not infrequently judges Japan — the first really rich nonwhite country — in racist terms, albeit in subtle ways most of the time.

Common Interests

Although both Japan and Canada tend to neglect each other in their focus on the United States, the most important member of the Japan-North America triangle, in fact they share

major common interests. These go far beyond the opportunities for expanding trade, investment, and technology interchanges, and relate in large part to the two countries' shared, but different, dependence on the United States.

Politically, as well as economically, no two countries have more at stake in an open trading world than do Canada and Japan — unless it is the United States, whose exports have now been vigorously expanding for more than a year. A nonprotectionist world would assure both countries of continued and growing trade with the United States. More importantly, it would also permit them to diversify their trade patterns, particularly in the Pacific Rim, and ultimately to become less directly dependent on the U.S. market.

Both also have a strong stake in the success of the market system. Japan's economic success is not based on government intervention, as so many people mistakenly believe, but on astute private-sector management, on spotting market opportunities early, and on adopting a highly competitive, high-quality, high-value response to them. It also depends on a society that promotes innovation and reduces resistance to change whenever it occurs. Canada would be better off if it could improve its record in all these respects.

The two countries also have a shared interest in the development of a society based on information and communications, in which value added through high-quality, technologically driven, and information-intensive goods and services, rather than through sheer manpower or cheap natural resources, will be the key element to sustainable growth. Canada, however, will need to apply these advanced skills to its resource industries as well as to manufacturing, since resources — albeit with much more sophistication in both its products and its processes — will continue to be an important element in the country's growth.

No two countries are more dependent than Canada and Japan on the success of international economic cooperation. If the world's leading economies can develop the right macroeconomic policies and coordinate them effectively, growth will

be vigorous, inflation and real interest rates will decline, confidence will rise, and the likelihood of a global debt crisis will recede. On the other hand, misguided or uncoordinated policies could lead to slowing growth, rising interest rates, a fall in living standards, and increased risks of world economic catastrophe from which both countries will suffer disproportionately. In Canada's case, this would be due to the impact on its resource and related manufacturing industries. Japan will suffer because of the protectionist backlash that such an international calamity would engender.

In particular, both countries have a special interest in the success of the Uruguay Round of multilateral reductions of tariffs and other obstacles to trade under the General Agreement on Tariffs and Trade (GATT). Trade is more than twice as important to Canada as it is to Japan. Each country, however, runs particularly high risks from the spread of non-tariff barriers, with which the GATT has hitherto failed to deal, and both could play a leading part in ensuring that they are dismantled. Both also have an interest in liberalizing international treatment of foreign investment. Many Canadians forget that Canada, like Japan, is the owner of a rapidly rising stock of foreign investment, a stock that is growing much faster than foreign investment in Canada.[1] Moreover, both are interested in freeing restrictions on international trade in services and finance.

Learning from Each Other

Despite their obvious differences, the two countries also have much to learn from each other about improving economic performance and policies. It is true that Japan is racially and culturally much more homogeneous than Canada — although it is not nearly as homogeneous as many of its citizens sometimes like to believe. It is also true that it lacks the space and resources that Canada enjoys, while benefiting from a social

[1]See, for example, Alan M. Rugman, *Outward Bound: Canadian Direct Investment in the United States*, CAC 54 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

discipline, a longer time perspective, and a willingness to adapt and change that Canada lacks. Yet these political and cultural differences should not obscure the fact that both share similar economic and social policy challenges, or that each could benefit from adapting and improving the best practices and policies of the other.

Japan, for example, needs to improve its stocks of social capital, public works, and housing, and might well adapt some of the relevant policies that have worked so successfully in Canada. Its North American distribution and marketing of sophisticated and innovative products, such as pharmaceuticals or specialty chemicals, could benefit from Canadian expertise — Japan's impressive marketing strengths are largely confined to mass-produced consumer goods. Canadians could also help Japan improve its understanding of the social and political dynamics that drive behavior in the United States.

In a wider sense, Japan almost certainly could benefit from studying Canadian tolerance of differing points of view. This quality of encouraging differences — adapted to Japanese needs — will be an increasingly vital intangible element in Japan's future economic growth, since that growth increasingly will depend on innovation, variety, and the successful organization of multinational companies.

Canadians, on the other hand, have a lot to learn from the Japanese about accepting the discipline of the marketplace in order to promote needed change as well as the competitiveness on which living standards ultimately depend. With important exceptions, especially in agriculture and the distribution system, governments in Japan like to reinforce market signals, avoid propping up failing industries, and dissolve rigidities that impede innovation. Japan has been much more willing than Canada to promote the shrinkage of uneconomic industries such as aluminum, shipbuilding, steel, and coal. Japanese steel employment, for example, fell from 459,000 workers at its peak in 1973 to 315,000 in November 1987, while the number of coal miners has fallen from 231,000 in 1960 to fewer than 10,000 today. While the story of Cape Breton's

uneconomic and heavily subsidized coal mines is not comparable in all respects, it is instructive to note that over the two decades before 1987, employment there only fell from 6,300 to 3,600.

Canadian businessmen could well emulate their counterparts in Japan when it comes to investing in the future. Canadian unions — without giving up their rights to represent the real long-term interests of their members — could certainly learn something about the gains to be had from working cooperatively to promote change and strengthen their employers' competitive position. In general, Canadians could benefit greatly from studying the Japanese quality of working together in a nonadversarial way to solve problems. Moreover, Canadians could always aspire to match the pride of the Japanese in doing a job well, whatever it is, their standards of courtesy, and the cleanliness of their towns and cities.

Why Now Is an Opportune Moment

There has probably never been a better opportunity in the history of Canada and Japan to improve relations between the two countries. This improvement could extend well beyond the normal ties of trade, investment, and technology to the whole field of international economic cooperation. It would benefit not just Canada and Japan, but also the United States, the triangular relationship between the three countries, and the whole global economy. This unique chance to strengthen the weakest side of the Japan-United States-Canada triangle has come about through a combination of circumstances centering, ironically enough, not on the two countries themselves, but on the United States.

Japan Looks Outward

The first circumstance is Japan's heightened awareness of the risk of being totally isolated by U.S. and world anger, which reached a peak in 1986, at the lack of openness of its economy and the one-sided nature of its trading policies. In the past

year or two, Japan has become increasingly aware of the danger to which the growing lack of credibility of its earlier market-opening measures had exposed it. Inaction, late and insufficient steps provoked only by strong outside (mainly U.S.) pressure, and minimal results from highly publicized programs that had promised significant changes — all had contributed to rising foreign anger, which protectionists around the world were exploiting fully.

The Japanese thus have come increasingly to see the value of building friendships and more stable relationships abroad, based more on a balance of interests and less on Japan's exploiting its competitive advantages to the maximum possible extent in the short term.

Japan has also recognized its lack of wisdom in relying so heavily on exports as the engine of growth. While such a policy may be effective in the near term — indeed, it may be essential if a country is running a serious trade deficit — it is shortsighted and self-limiting for a country, such as Japan, that already has a large export surplus. Because of its lack of resources, it is inevitable that Japan will run a substantial surplus on manufactured goods in order to pay for its imports of food and raw materials. Excessively large surpluses, however, especially if accompanied by an apparent reluctance to accept manufactured imports, are likely to arouse resentments abroad. Japan's exaggerated emphasis on manufactured exports led to unbalanced and narrow growth — more than 50 percent of the country's exports in 1986 came from ten products and some 60 percent came from only 30 firms. These large export surpluses also induced a protectionist backlash, and put severe upward pressures on the yen. In effect, the cross-subsidization of exports, financed by high prices in the domestic market, imposed a substantial tax on Japan's citizens, who — as they have since shown — preferred to raise their standards of living and domestic consumption instead.

While the reaction of foreigners was important, it was ultimately the impact of the high yen that convinced the Japanese in the spring of 1987 to introduce a program to reorient and

reshape their economy. This wide-ranging program consisted of stimulating domestic demand through increased investment in public works; promoting consumption through tax cuts and diverting production from exports to domestic markets; doing more offshore sourcing; investing more abroad; increasing foreign aid and technology transfers; deregulating the economy; and — importantly — encouraging the benefits of deregulation and increased competition to flow through to consumers.

This package of fiscal and other measures has begun to have a real impact on trade and has led to more constructive relations with other countries, particularly the United States. It has clearly increased aggregate demand in Japan and globally, and facilitated many of the necessary adjustments in the Japanese economy. As will be noted later, however, measures are also needed to restructure the backward, inefficient, and uncompetitive segments of that economy, particularly in agriculture, distribution, and some family enterprises. These sectors are in striking contrast to the modern, innovative, and competitive portions of the economy, which will never achieve its full potential — or solve its problems with the rest of the world — until these pockets of protectionism and uneconomic activity are addressed.

In this context of a broad rethinking of Japanese economic policy, a small but growing number of Japanese see Canada as a potential friend and ally. Its long relationship with Japan has, on the whole, been a constructive one, unmarked by the "Japan-bashing" that has sometimes characterized the United States' relationship with Japan. Canadian-Japanese friendship has been strengthened in recent years by the persistent and intelligent efforts of Canada's embassy staff in Tokyo, led by the Ambassador, Barry Steers. Mr. Steers is widely known and respected in the Japanese community, and his toughness, diplomacy, and broad knowledge of the workings of Japanese society have contributed significantly to Canada's better image in that country.

In addition, Japan's interest in Canada was stimulated by the report of a Japanese economic mission to Canada — the

Kanao mission — in the fall of 1986, which was highly complimentary to this country and its prospects.[2] This was in sharp contrast to a similar report a decade earlier that had been harshly, but justifiably, critical of Canada's economic policies, union and management practices, and attitudes toward competition and change.

The Kanao report also made a worthwhile beginning in shifting Japan's perspective in another sense. Too many Japanese have seen Canada simply as a purveyor of resources and raw materials. The report, however, laid special emphasis on the high growth — and many opportunities for Japanese-Canadian cooperation — in the advanced manufacturing, high technology, and efficient value-adding industries that are an increasing part of the Canadian economy.

Canada-U.S. Free Trade

The most powerful factor in increasing Japanese awareness of Canada has been the long negotiation and recent conclusion of the Free Trade Agreement with the United States. Many Japanese jumped rather quickly to the view that this was another inward-looking, protectionist move aimed at excluding Japan from a "Fortress North America." Others, however — although still a minority at this stage — do not see the deal as one in which their Canadian friends disappear behind a new and impenetrable barrier. Rather, they see it for what it is: a move by two of the world's greatest proponents of freer trade to show other countries that protectionism is not the only alternative available to them. In this view, Canada is seen as a friend inside the U.S. gate, a friend who will be more sensitive to, and concerned by, Japan's position than the United States sometimes is.

Few people in Japan understand, however, that a stronger, richer Canada can be not only a more forceful advocate of Japan's views with the Americans, when that is justified, but

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[2]Japan, Ministry of International Trade, *Report of the Trade and Investment Mission to Canada* (Tokyo, 1987).

also a more vigorous competitor in the Pacific market, particularly for manufactured products. The elimination of the progressive U.S. tariff against Canadian manufacturers will remove the disincentive to process resources in Canada for U.S. customers. It will thus give Canadian manufacturers access to much larger markets. The lower costs accompanying these longer production runs will tend to shift Canadian resource-based exports from the raw state to forms in which more real value is added. (This may, incidentally, lead to a better balance of trade between Japan and the various regions of Canada.)

Most Japanese also do not appreciate that the Free Trade Agreement's most significant impact on Canadian manufacturers will be an intangible one: to enlarge their export ambitions, improve their confidence, and enhance their aggressiveness and sensitivity to customer desires, all of which are important qualities to achieve sustained success in selling in Japan.

In summary, two developments have combined to bring about a situation that offers Canada significant opportunities to expand its trade, investment, and research and development ties with Japan. First, the impact of the high yen and trade tensions between Japan and the United States have made it necessary to stimulate and restructure the Japanese economy. Second, the conclusion of the Canada-U.S. Free Trade Agreement has promoted a greater Japanese awareness of Canada.

Yet Canada now has a wider opportunity as well. As a friend of both other parties in the triangular relationship, its economic strengths and credibility put it in a good position to mediate disputes between the United States and Japan, to promote freer trade between them, and to help bring about a constructive outcome to some of the difficulties confronting them. All three countries, after all, have a strong interest in a market-oriented and open international trading and economic system. They also share an interest in bringing about a climate in which investment can flow freely, change is encouraged, and needed adjustments can take place easily.

Most importantly, all three have an interest in the unfettered exchange of ideas and technology and in the multinational sharing of research projects, some of which are getting too big for any one country to handle alone. The progress of Japan's economy, in particular, is highly dependent on continued access to the technological progress and product development originating in the United States, which is still by far the world's most dynamic, original, and innovative economy. Without this "golden wind" of discovery, innovation, and product development from across the Pacific, the Japanese economy would make much slower headway through the seas of world competition. It also goes without saying that the Canadian economy, too, continues to be highly dependent on access to technology originating outside its borders, especially in the United States.

Outline of the Study

Given that satisfactory global growth is the key to staving off protectionist pressures and reinstituting progress toward a more open world economic system, without which Canadian-Japanese trade prospects are unlikely to be healthy, the next chapter looks at Japan's changed macroeconomic policy and the prospects for more balanced world growth. Inevitably, as in all aspects of Canadian-Japanese relations, this will also involve a look at the chances of a successful readjustment on the part of the United States. Chapter 3 then looks at some of the principal structural barriers to trade — cultural, political, and economic — and the prospects for restructuring an expanding Japanese economy in order to reduce these barriers. Chapter 4 attempts to sketch some current characteristics of trade, investment, and technology flows between the two countries and the potential for expanding these flows in the future. The final chapter indicates some of the economic issues that both Canada and Japan need to study and resolve, and suggests the directions in which the two countries ought to point their policies in the next few years.

2

Getting the Macroeconomic Setting Right

No single economic factor is more important for Canada, or for the Canadian-Japanese trading relationship, than the global macroeconomic environment. If this setting is right, and world demand and growth are satisfactory, Canada's prospects for more extensive ties with Japan are excellent. Canada has little influence, however, on how the world's major economic levers are set; that is determined primarily by Japan and the United States. It is vital, therefore, to understand this broader background against which the Canadian-Japanese relationship will develop in the next few years.

Japan's Policy Actions

In late 1986, the painful pressures of the high yen finally induced a real sense of urgency in Japanese businessmen and policymakers. The yen, in fact, eventually more than doubled in value from its February 1985 low of 265 to the U.S. dollar to well below 130 in the first quarter of 1988. This crisis — referred to in Japan as *endakafukyo* — when combined with foreign, especially U.S., criticism of earlier inadequate or cosmetic measures to cut Japan's large trade surplus, drove home to the Japanese the folly and shortsightedness of depending on a policy that relied excessively on unbalanced trade as the engine of growth. It also helped to establish a national consensus that more vigorous domestic demand, accompanied by a substantial expansion of imports, had to be the driver of Japanese progress in future.

Export growth unmatched by that of imports inevitably will lead to a rising currency. Despite Japan's high savings rate and ongoing role as a provider of capital to the rest of the world,

it could not count on capital exports to rise continuously and thus offset the upward impact on the yen of the rising trade balance flowing from a policy emphasis on export-led growth. Indeed, capital movements induced by expectations of a rising yen will be destabilizing in the short term, adding to the upward pressure as money flows toward — not away from — Japan. In the longer term, strong economic growth and the liberalization of financial markets could also be expected to attract additional capital to Japan on a permanent basis. Thus, the only option for an export-led economy that wants to maintain its growth is to encourage domestic sources of expansion and imports as well.

Stimulating Demand

This message at last hit home, aided by two reports of the Mayekawa task force about the need to bring about a longer-term restructuring, as well as stimulation, of the Japanese economy, which received wide attention and support in Japan.[1] Thus, a program emerged in the spring of 1987 designed both to stimulate domestic demand and to divert more of that demand to imports. The fiscal aspects of the program amounted to 6 trillion yen (about U.S.$42 billion), composed of some 5 trillion yen of outlays for public works and housing and 1 trillion yen of tax cuts. Two earlier programs, announced with considerable fanfare, in reality had involved nothing more than budgetary rejuggling and even, in some instances, cuts. This new program, however, was designed to work — and it has.

Despite an appreciation of the yen of some 17 percent, real GNP in Japan rose by 4.2 percent between the end of 1986 and the end of 1987. The view of public and private economic agencies in Japan is that the program of fiscal stimulus probably accounted for close to 1 percentage point of this amount,

[1]The Mayekawa task force, known officially as the Advisory Group on Economic Structural Adjustment for International Harmony, submitted its first report to Japanese Prime Minister Yasuhiro Nakasone on April 7, 1986.

a sizable contribution to world expansion in a year when there was concern about global growth prospects. Largely because of this successful program, domestic demand grew by more than 5 percent while the foreign trade sector contributed a negative 1.5 percent to Japanese production. This is a major shift in the source of growth for an economy that was getting some 40 percent of its impetus from the foreign sector in 1983; even in 1984 the figure was more than 20 percent.

Nor does this program to stimulate and change the origins of Japanese growth seem destined to be merely a "one-year wonder." Public investment, which had fallen for the seven years up to 1986 from 21 percent to about 15.5 percent as a percentage of the budget, will probably grow faster than the budget as a whole for the next several years. There is ample need for such expansion. A "wish list", by no means complete, of necessary public works in Japan amounts to more than 400 trillion yen — well over U.S.$3 trillion. One striking example of the weak social capital structure in Japan is that only 36 percent of the country's houses are connected to a sewer.[2] Visitors to Japan note the shortage of public facilities at every turn: roads and streets are narrow and crowded, and there is a serious lack of parks and parkland in and around major metropolitan areas.

Partly as a result of proceeds from the sale of some of the government's holdings in Nippon Telephone and Telegraph (NTT), which is being privatized, the budget deficit will not grow significantly in the next two years. The federal deficit in Japan is forecast to run at about 2.5 percent of GNP, considerably lower than Canada's estimated 5 percent. Much of the Japanese deficit is being incurred to finance investment. It thus will generate additional income to pay for the resulting higher finance charges — unlike Canada's deficit, which is for government consumption. Moreover, since savings rates in Japan are almost double, and interest rates about half, what

[2]The comparable figure in France, hardly a world leader in public sanitation facilities, is 65 percent.

they are in Canada, financing a public-sector deficit is much easier in Japan than it is in this country.

While Japanese demand will get continuing support from a higher level of public works outlays in 1988, the main source of stimulus in fiscal year 1988[3] will come from consumption expenditures, which will be spurred by year-end income tax cuts amounting to 1.3 trillion yen. In 1987, this stimulus to consumption amounted to 1 trillion yen, or about one-quarter of 1 percent of GNP. In fiscal year 1988, further impetus will come from tax reform. This will shift some of the fiscal burden from income to sales taxes, while bringing about a net revenue decrease of 2.4 trillion yen. Japanese authorities expect this to add perhaps 0.2 percent to GNP growth. It will stimulate private consumption and housing by the decline of the total tax burden on households, and it will also encourage business investment as a result of higher profits stemming from lower taxes and higher demand growth.

Introduction of tax reform and a general consumption tax was blocked in 1987 by vigorous opposition — not least from small businessmen and merchants who, while not seriously affected themselves, would have to keep tax records that might reveal how seriously they underpay their taxes. A general consensus has since developed, however, on the need for such reform, and Prime Minister Noburu Takeshita has been more sensitive than was his predecessor to the views of its opponents. Thus, rates have been lowered (they are now to be 3 percent rather than 5 percent); exemptions have been widened to include medical, education, and welfare items; and the timing for implementation has been delayed to April 1989. Although nothing is certain in the mysterious world of Japanese politics, agreement on tax reform in 1988 seems a

[3]In Japan, the fiscal year runs from April 1 to March 31, and is measured by the calendar year in which it begins. Thus, fiscal year 1988 refers to the period April 1, 1988, to March 31, 1989.

distinct possibility despite continuing opposition from the non-governmental parties.[4]

Tax reform will further stimulate already vigorously growing consumption. Most analysts now forecast the Japanese economy to grow by about 5 percent in calendar year 1988, and by more than that in fiscal year 1988 (in fiscal year 1987, growth was 4.9 percent). Considering that the foreign sector's influence on Japanese output will again be negative to the extent of over 1 percent of GNP, the rise in domestic demand will be substantial. Total GNP growth of just over 5 percent in 1984 and 4.7 percent in 1985 was achieved in years when the foreign trade sector was providing additional stimulus. Only in 1986 did total Japanese growth weaken, to 2.5 percent, as a result of a lack of real measures to reshape the economy in the face of the rising yen.

Fostering Adaptability

Japan's capacity to resume rapid growth in the face of a dramatic currency change — as if the Canadian dollar suddenly were to rise to U.S.$1.40 — has not only been the result of macroeconomic policy, even though monetary policy, too, has been stimulative. (In fiscal year 1987, the money supply grew at more than 10 percent per annum, a rate that has since been slowed slightly as fears of inflation have increased.) Nor has this adaptive capacity been due to the other government measures designed to restructure the economy, such as deregulation, dismantling of some trade restrictions, increased foreign purchases by public agencies, steps to modernize agriculture, attempts to free up land use, and measures to make the tertiary manufacturing and distribution sector more competitive, since these have hardly yet begun to bear fruit.

Instead, Japan's ability to grow despite a rapidly rising yen is testimony to the amazing resilience and adaptability of the Japanese economy. This, in turn, stems from many factors,

[4]The opposition is now using the Recruit scandal, which involved insider trading by highly placed Japanese, as a reason to block progress on the tax reform issue.

including a culture in which the concept of what might loosely be called "self-respect" does not encourage people to persist for long in pursuing an action or behavior that is clearly mistaken, wrong, or simply inferior to another. Thus, in the Japanese view, it is not shameful to alter behavior or change direction radically. Indeed, the more embarrassing course is to persist in conducting oneself in a way that is clearly out of touch with the times and obviously not to the advantage of either the group or the individuals concerned.

Thus, when market forces, which continued to manifest themselves in a high and rising value of the yen, dictated a switch in policy and behavior, it was accepted — at least in government and the market-oriented sectors of the economy — that a switch had to be made. The situation was examined and decried, and the United States given more than its not-inconsiderable share of the blame, but the reality was acknowledged and a consensus developed in favor of a radical change in policy. The result was *kokusaika* — the internationalization of the Japanese economy. In North America, there is a widely held perception — particularly by left-wing commentators — that government planning or leadership is primarily responsible for Japan's success. *Kokusaika*, however, was a market-oriented response reflecting the fact that Japan's success has been due to a willingness of most of Japanese society to adapt to new realities and changing market forces.

Reducing the Trade Surplus

These policy and cultural factors, together with lower oil prices and the impact of the higher yen in lowering the cost of imported raw materials and components, have combined to ensure that the Japanese, at least, are making good progress toward promoting growth of the world economy and reducing payments imbalances. The percentage gap between Japanese exports, which in 1986 were running at 10.7 percent of GNP, and imports, at 6.5 percent, is now narrowing quite sharply. In the first quarter of 1988, they were 9.0 percent and

6.7 percent, respectively. Imports, which were only about 50 percent of the value of exports in 1986, were almost three-quarters of them in the first half of 1988.[5]

Although Japan's trade surplus widened slightly in dollar terms in 1987, from U.S.$92.8 billion to U.S.$96.4 billion, in both yen and volume terms the underlying improvement that began in late 1986 gathered speed. Exports in 1986 declined by 16 percent in yen terms and 0.6 percent in volume terms. In 1987, exports declined a further 6.0 percent in yen terms, although they edged up 0.3 percent in volume terms. Japanese imports, however, which had risen 9.5 percent in volume terms in 1986, were up by a similar 9.3 percent in 1987.[6] Indeed, since the Plaza Accord in late 1985,[7] Japanese import volumes have risen 45 percent while export volumes have barely changed.

Even more encouraging has been the sharp rise in Japan's manufactured imports. In the first quarter of 1988, they were up almost 50 percent over a year before and constituted almost 50 percent of Japanese imports, virtually double the percentage only three years earlier. For instance, imports of foreign cars, including those from the United States, are increasingly popular. While still a small share of the market, they were 32.2 percent higher in August 1988 than they were a year earlier, marking the fifty-sixth consecutive month such imports had increased. The prevailing wisdom had always been that Japan would never be a significant importer of manufactured goods.[8] Japan's total imports from the United States — which

[5]The actual figures were U.S.$91.8 billion for imports and U.S.$125.4 billion for exports.

[6]Bank of Japan, *Economic Statistics Monthly*, various issues.

[7]In the Plaza Accord, named for the New York hotel where the meeting convened, the so-called Group-of-Five countries — France, Japan, the United Kingdom, the United States, and West Germany — committed to undertake coordinated intervention in foreign-exchange markets to bring about a depreciation of the U.S. dollar.

[8]Because of the nature of Japanese resource endowments and, to some extent, import propensities, Japan accounted for only 5.6 percent of world manufactured imports in 1986 compared with 20.0 percent for the United States, even though Japan's economy is more than half the size of that of the United States. See General Agreement on Tariffs and Trade, *International Trade 1986-87* (Geneva: GATT, 1987), pp. 159, 163, 194.

continue to lag, relative to its imports from the four "little tigers" of Hong Kong, South Korea, Singapore, and Taiwan — were up by 40 percent in the first half of 1988, and 33 percent in June compared with a year earlier. A substantial part of these increased imports is manufactured goods.

These sharply increased imports of manufactured goods and components — from the "little tigers" as well as from Europe, the United States, Canada, and other Pacific Rim countries — reflect the sharply increased degree to which Japanese companies are sourcing abroad. Growth in Japanese domestic demand, the highly competitive response of industry, and continued growth in foreign markets has meant that, despite this increase in foreign sourcing, Japanese industrial production in June 1988 was up 9.1 percent over a year earlier. Rapid growth in domestic demand and the continuing strength in exports — volumes have begun to grow again in 1988 — have also meant that the aggregate adjustment process in Japan has gone relatively smoothly. GNP, which grew at the astonishing rate of 11.3 percent in the first quarter of 1988, was 6.7 percent above its level of a year earlier, while the unemployment rate at mid-year was 2.4 percent, against a high of just over 3 percent in the first half of 1987.[9]

Japan has clearly been playing its part in providing needed stimulus to the international economy. As will be seen later, however, it still has much more to do in reducing barriers to trade and restructuring the backward sections of its own economy. It seems obvious from these events that nontariff barriers are by no means a predominant explanation of Japan's surplus. Indeed, thoughtful analysts put their impact at no more than U.S.$10–20 billion in 1985.[10] These barriers have

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[9]Because of the different way in which unemployment is measured in Japan, these figures should be doubled to make them comparable to Canadian statistics.

[10]See, for example, C. Fred Bergsten and William R. Clive, *The United States-Japan Economic Problem* (Washington, D.C.: Institute for International Economics, 1987); and Robert Z. Lawrence, "Imports in Japan: Closed Markets or Minds," *Brookings Papers on Economic Activity* (1987:2): 517–548.

been falling for many years, and at an accelerating rate since 1985. Their precise impact, however, remains hard to measure precisely because of the complex but subtle cultural and social factors that lead to them.

How rapidly Japan's international trade and current account balances will be restored to a condition that is politically and economically sustainable in the long term is, however, a matter of continuing debate. Analysts at Japan's Ministry of International Trade and Industry (MITI) conclude that the effect of the J-curve alone on Japanese exports amounted to more than U.S.$15 billion in 1986, with the low oil price in that year accounting for just about as much.[11] Japan's slower growth rate in that period might have added another U.S.$10 billion to its trade surplus. The low level of nonoil commodity prices, which have since begun to climb, would have contributed a smaller amount. As these forces reverse themselves — reinforced by the policy of deliberately encouraging imports into Japan — it is not inconceivable that some U.S.$50 billion of the 1987 surplus of U.S.$96 billion could disappear by 1990 — perhaps early in that year.

In fact, an improvement of some U.S.$20 billion seems quite attainable in calendar year 1988, although the current account will not improve as much because of rising Japanese earnings on its overseas investments. Despite the renewed growth of exports, up almost 16 percent to U.S.$125 billion in the first half of 1988, imports rose by more than 34 percent, to almost U.S.$92 billion. The trade surplus thus fell by 16 percent, to U.S.$33.7 billion from U.S.$40.1 billion a year ago, with imports, if anything, gathering speed. The bilateral surplus with the United States fell by 15 percent, from U.S.$24.6 billion to

[11] Japan, Ministry of International Trade and Industry, *White Paper on International Trade* (Tokyo, 1987), pp. 11, 15–16. The "J-curve" describes the response of the trade balance to a depreciation in the exchange rate. After a depreciation, import prices in local currency tend to increase, thus worsening the trade deficit initially. As time passes, the increased price of imports and the decreased price of exports in foreign currency terms alters their competitiveness, leads to changes in the volume of trade, and brings about an improvement in the trade deficit.

U.S.$20.9 billion. In June 1988, imports from the United States were up 33 percent compared with a year earlier, while exports were up just 8 percent. It should be noted, however, that the U.S.$7.3 billion value of Japanese exports to the United States in that month was still virtually double that of U.S. exports to Japan.

Some of these smaller Japanese trade surpluses have been accompanied by larger surpluses between the "little tigers" and the rest of the world than would occur in the absence of Japan's increased sourcing of its export industries in those countries. Nevertheless, the "tigers" are swinging into better balance with the United States, despite the fact that their currencies have appreciated less against the U.S. dollar than has the yen — the currencies of Hong Kong and Singapore have not appreciated at all, while that of South Korea has appreciated by 20 percent and that of Taiwan by 30 percent. Yet, U.S. exports to the "tigers" in the first five months of 1988 were up 40 percent, compared with 26 percent to all industrial countries, and the United States' bilateral deficit improved by U.S.$2.9 billion, to U.S.$11.2 billion.

Will the United States Do Its Part?

While the Japanese side of the macroeconomic adjustment process is now working satisfactorily after a number of false starts, there is considerable concern that international balance will not be restored because of failure on the part of the United States. According to this pessimistic view, best represented by Peter Peterson,[12] the United States will not voluntarily take the necessary action to curtail both private and public consumption, raise savings rates, and increase competitiveness. Many of the pessimists foresee continued U.S. overconsumption causing persistent trade deficits. Under this scenario, such deficits will be rectified only by continued substantial depreciation of the dollar — perhaps in the order of a further 20 percent — accompanied by a hard landing as a result of

[12]Peter Peterson, "The Morning After," *Atlantic Monthly*, October 1987.

a complete loss of confidence in U.S. policy. At that point, investors would go on strike, U.S. interest rates would have to be raised dramatically, and a sharp recession would ensue until balance was ultimately restored.

Those who believe in this gloomy outcome advance a variety of structural reasons why the United States will not easily bring about the cumulative adjustment of up to U.S.$200 billion in its balance of payments that is required over the next few years. This sum is equal to about 5 percent of U.S. GNP — materially less when one allows for U.S. growth during the next five years — and is made up of just over U.S.$150 billion to eliminate the current account deficit and U.S.$35–45 billion to service the United States' net foreign debt, which is forecast to grow significantly before the situation is turned around sometime in the 1990s.

Tackling the Twin Deficits

One of the principal reasons given for this probable U.S. failure to adjust is a political unwillingness to deal with the deficit in an election year — or, perhaps, at any time unless there is a major crisis. This argument, however, ignores the rigorous steps the United States already has taken to stabilize and reduce its deficit, which fell by U.S.$70 billion in 1987. Alternatively, it attributes past progress to "special factors" — such as the fact that, in 1987, the U.S. government made large collections from capital gains taxes prior to the start of the new system, with its higher rates, in 1988. These same people forecast a big rise in the deficit in 1988 when, in fact, it will be about the same as it was in 1987 or lower.

It is also easy to underestimate the power of a new president to take action: he would be unfettered by President Reagan's almost theological reluctance to impose new taxes. While major new income or corporate taxes are unlikely, consumption taxes would be acceptable and appropriate in a society whose major economic difficulties stem from a tendency to overconsume. Revenue could be increased by U.S.$50 billion,

with higher excise taxes on alcohol, cigarettes, and gasoline; a 25-cents-per-gallon tax on the latter would raise U.S.$25 billion alone. Together with a more determined assault on nonmilitary spending and possible savings on defense outlays as a result of improved cost controls and agreement with the Soviet Union, these measures could bring the budget situation into virtual balance fairly quickly.

Turning to the private side of the U.S. economy, much is made of the fact that U.S. import prices have not risen in parallel with the decline in the dollar. There was a long lag in this adjustment because import prices and margins had been maintained earlier when the dollar was overvalued. They have begun to rise sharply, however, and are now 10 percent above their fall 1986. In fact, partly because the yen is overvalued in terms of purchasing power — by as much as one-third according to some analyses, although much depends on the base period chosen — the margins of Japanese exporters to the United States are now being squeezed particularly seriously, and import prices are likely to rise further.

It is also argued that Americans are so addicted to imports, and so dependent on them, that they will not stop using them at any price. *Business Week*, for example, describes imports as "an addiction that U.S. consumers can't seem to kick," and says, "consumer demand for imports remains voracious."[13] It is sometimes suggested that there is now no alternative U.S. source of supply for many goods or that, because of low investment, U.S. industry lacks the capacity to produce exports and import-competing goods. These arguments were heard more frequently in 1987 than they have been since because of the strong revival of U.S. manufacturing output, competitiveness, and business investment, which was up over 16 percent in the first half of 1988. Still, it is sometimes argued that U.S. businessmen will simply raise prices to take short-term advantage of the devalued U.S. dollar rather than

[13]James C. Cooper and Kathleen Madigan, "Business Outlook," *Business Week*, April 4, 1988, pp. 25–26; idem, "Business Outlook," *Business Week*, August 1, 1988, p. 21.

be farsighted and invest to build market share at home and abroad. There are also those who claim that the United States does not do enough research to remain competitive or up to date technologically.

Adjustments in U.S. Industry

There are normally lags of varying length in bringing about needed economic adjustments, but it is unwise to conclude, therefore, that they will never occur. After all, the United States' present difficulties have been developing since 1980, when the U.S. current account was last in rough balance. The processes of response to a correction were not always evident, and certainly could not be instantaneous. Meanwhile, the "structuralists" — the people who assert the economy will not adjust — tended to claim that the United States was becoming "deindustrialized" and incapable of competing in manufacturing. A look at the facts is, however, a healthy antidote to such slogans of doom and gloom. They show that "deindustrialization" in the United States is about as likely as the "hollowing out" of Japan that has recently been getting so much press in that country.

In fact, U.S. manufacturing still accounts for the 23 percent of GNP that it did 30 years ago, and its overall productivity — despite the wailings of some — is still the world's highest in absolute terms. Moreover, from 1983 to 1987, manufacturing's share of U.S. GNP did not go down despite the massive overvaluation of the U.S. dollar, and its growth from 1980 of more than 3 percent per year is better than that of any other member of the Group of Seven (G-7) major industrial countries except Japan.

Productivity in U.S. manufacturing has grown sharply. At 4.8 percent annually from 1982 to 1987, it was double the rate of the previous 20 years. In durables, the rate of productivity gain during the past five years has been over 7 percent, more than three times that of the two previous decades. This is much more than the normal cyclical recovery, partly because of the

intense competition to which U.S. industry has been exposed. It is also, however, the result of a large rise in physical investment and in research and development. While net investment in plant and equipment as a percent of U.S. GNP fell to a low of 4.7 percent in the 1980s, compared with almost 7 percent a decade earlier, gross investment has been at an all-time high of over 11 percent to GNP. It is true that assets — such as computers, software, and tooling — are shorter lived than they used to be. It is also true that there has been a pronounced shift away from industries with long-lived assets. Rising depreciation charges, however, are fully compensating for these changes. Thus, these high gross investment levels probably have made U.S. industry more efficient, more modern, and more productive than at any time since the early 1960s.[14]

Investment in research and development in the United States has also grown rapidly, to 2.8 percent of GNP in 1987 — about the same as in Japan — from 2.2 percent of GNP in the 1970s. Industry R&D — mainly in manufacturing — has grown at an inflation-adjusted annual rate of 8 percent so far this decade. Moreover, increasing attention is being paid to quality in a wide range of industries, and while Japan has captured the lead in some of them, the United States is still the world's best in many more. Thus, despite the continued and impressive improvement in Japanese manufacturing techniques and efficiency stemming, in part, from higher procurement of foreign parts and from focus on lighter, more technologically intensive, value-added products, the overall competitive position of U.S. manufacturing has been improving in recent years and will contribute to a better trade balance with Japan.

The volume of U.S. exports, reflecting this investment and strengthening competitive position, rose by 44 percent from the beginning of 1986 to the second quarter of 1988 and is

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[14]See, for example, "U.S. Competitiveness: The Untold Study," *Morgan Economic Quarterly*, June 1987; and Robert S. Gay, "U.S. Competitiveness: Making a Comeback," *Economic Perspectives* (Morgan Stanley), December 9, 1987.

continuing to grow. As noted above, U.S. exports to Japan and other Pacific Rim countries are rising vigorously. Manufacturers are continuing to invest in new capacity and are accelerating expansion plans, despite still having room to expand output from present plants in many industries. Meanwhile, U.S. imports are showing signs of slowing in real terms, although they were still growing faster than U.S. domestic expenditures until the second quarter of 1988, when they actually declined slightly. This decline may continue through the rest of 1988, despite the high import intensity of spending on durables and machinery and equipment and the persistence of strong consumer demand.

Despite the enthusiastic acceptance of U.S.-made Hondas in Japan, exports of Japanese products from branch plants in the United States are still relatively small at this stage. They do, however, reflect the underlying facts of increased capacity and competitiveness in the United States and the tastes of Japanese consumers for good-quality U.S. goods. With the United States' trade balance having improved in volume terms for some time — although only very recently in dollar terms — it would not be surprising to see an improvement of up to U.S.$50 billion in 1988, with the figure running at an annual rate of under U.S.$100 billion by year-end.[15] On a national accounts basis, the deficit ran at an annual rate of U.S.$130 billion in the first half of 1988, against U.S.$160 billion a year earlier — in the second quarter, the rate was U.S.$120 billion. Also in the first half of 1988, the actual U.S. deficit on visible trade fell to U.S.$66 billion from U.S.$78 billion in 1987; the improvement from 1987's bad second half ought to be even more marked. In fact, in real terms, the U.S. merchandise trade deficit has been improving for

[15]Published figures tend to overstate the U.S. deficit. Owing to statistical discrepancies, world imports have been "exceeding" world exports by as much as U.S.$100 billion, which is clearly impossible. The figure was U.S.$45 billion in 1987, and the leading U.K. stockbrokers Phillips & Drew estimate that about U.S.$10 billion of this discrepancy is the result of an understatement of U.S. exports; the Japanese figures are barely affected.

almost two years on a national accounts basis, from its low point of U.S.$183.4 billion in the third quarter of 1986 to U.S.$113.9 billion in the second quarter of 1988.

Summary

In short, on both the U.S. and Japanese sides of this vital bilateral relationship, the prospects are relatively good. While the danger of overheating and a resulting buildup of inflationary pressures is real, the macroeconomic climate — the background for flows of trade, investment, and technology between Canada and Japan — is a good deal more favorable than one would have dared to hope in early 1987. Before turning to look at the prospects for Canadian-Japanese economic relations, however, this study examines some of the structural changes taking place within Japan's expanding economy, since these, too, will have an important influence on the size and scope of the business ties between the two countries.

3

Restructuring an Expanding Japanese Economy

Macroeconomic factors are leading to a much more vigorous expansion of domestic demand in Japan than anyone but a few optimistic officials expected in early 1987. Major shifts are also occurring within this dynamic economy. Most of these changes are trade promoting and tend to weaken the powerful governmental, cultural, and private nontariff barriers that have impeded the growth of exports — particularly manufactured exports — from Canada and other countries to Japan. These barriers were never completely impenetrable with enough persistence, and many were already being eroded as a result of external pressures and increased competition stemming from the high yen.

What is new is the increasing awareness of the Japanese themselves that export growth and stability of the yen are only compatible if imports are encouraged to grow vigorously as well. Both public and private policy are now aimed at dismantling these barriers — in an admittedly Japanese way, and sometimes too slowly and with too much respect for vested interests. Thus, Canadian exporters to Japan will continue to face substantial nontariff and other barriers arising from cultural and political factors.

In a society regulated as much by social custom as by government, the forces making for reduced imports are complex, deep-seated, and easy to oversimplify. At the sociocultural level, centuries of bureaucratic control and imposed and acquired social values have tended — at least until recently — to make Japanese society more than usually resistant to foreign ideas and goods. This is particularly true of agriculture, and the smaller, inefficient manufacturing, distribution,

and other service sectors that tend to act as shock absorbers for the more competitive and technologically advanced sectors of the economy.

Agriculture

A number of factors have combined to create a climate in which the Japanese accord agriculture a high value and think that self-sufficiency serves national ends. These factors include a relatively heavy population density — although not nearly as great as in some European countries — previous geographic isolation, and food shortages at the end of the Second World War. Japanese attitudes toward agriculture are nurtured by powerful propaganda from agricultural interests and are reinforced by the classic political overrepresentation of farmers. Moreover, because of favorable tax treatment, a good deal of land in urban areas — some 6 percent in Tokyo, for example — is still in agricultural use despite an intense shortage of land.

The result is that consumers in Japan transfer over U.S.$100 billion annually to farmers and spend almost twice as much of their incomes on food as Americans do — 26 percent compared with 15 percent. In some instances, farmers receive up to eight times the world price for their rice, and wholesale and consumer prices are six times those in the United States. Imports of rice are banned, the result of political pressures and a semimystical obeisance to national self-sufficiency and to the virtue of farmers. Even if rice imports were allowed, however, the Japanese taste for sticky rice might mean that local farmers would hold a higher share of the market than straight economics would suggest. Similar, if less dramatic, comparisons exist in other products, including wheat and beef.

The combined influence of greater consumer awareness — induced, in part, by increased foreign travel and the continuing complaints of other governments — and a change in the balance of political power toward the urban "salary men" is beginning to diminish the farmers' power. Moreover, the aver-

age full-time employee in agriculture is aging rapidly, and the proportion of the population involved has fallen from 20 percent to fewer than 5 percent in the past 20 years; total employment in the industry has fallen in parallel.[1] In fact, some 70 percent of Japanese "farm" income is now from non-farm sources. Reflecting this slowly changing balance of political forces, the support price of rice was reduced in 1987 by 6 percent and in 1988 by 4.6 percent, the first reductions since the end of the Second World War. Nevertheless, because of the appreciation of the yen, the gap between Japanese and world rice prices has actually widened since the end of 1986.

The intricate web of political and business considerations, cultural and social factors, and multilayered relationships that exists in Japan is difficult for a westerner to penetrate easily or to understand fully. This is particularly the case in such traditional and slowly evolving sectors of the economy as agriculture. For example, Nokyo, the huge and powerful farm cooperative which employs half a million people, or one of every 12 farmers, is reputed to maintain its enormous political influence with contributions of about U.S.$110 million a year to members of the ruling Liberal Democratic Party (LDP).[2] In addition to being one of the world's largest banks, a major Japanese insurance company, and a significant manufacturing firm with thousands of retail outlets, Nokyo has close ties to consumer groups.

In 1987, a coalition of 18 consumer organizations, representing some 20 million people, came out against the "unprincipled liberalization of food imports" and also said that rice imports "should never be liberalized." The president of the

[1]"When the Salt of the Earth Loses Its Savour," *The Economist*, February 20, 1988, pp. 31–32. Four-fifths of the rice in Japan is grown on undersized plots by part-time farmers, many of whom benefit more from "tax farming" than from commercial agriculture. Only 9 percent of rice farmers cultivate 1.5 hectares or more, and of the 4.2 million farms in Japan, only 631,000 are worked full time by those who depend entirely on agriculture ("Yesterday's Farming," *The Economist*, August 20, 1988, pp. 58–59).

[2]Some reports indicate that the farm lobby can still count on the votes of about 200 of the 445 Liberal Democrats (see "When the Salt of the Earth Loses Its Savour," *The Economist*, February 20, 1988, p. 31).

Consumers' Union of Japan has said that it is time to strengthen its relationship with Nokyo, and that there should not be a conflict, but an intimate relationship, between food producers and consumers. One symbol of this relationship is that, once a week, Nokyo delivers a box of milk, meat, vegetables, and fruit to the Consumers' Union headquarters. The president of the Consumers' Union says, however, that he takes no direct financial contributions from Nokyo, although it pays him an honorarium, plus expenses, to speak at conventions of its youth and women. Nokyo also bought one-sixth of the Consumers' Union's publications in one year.[3]

Obviously, Japanese agriculture's misleading argument that Japan should be self-sufficient in food — even with blatant protectionism, it produces barely 50 percent of that country's requirements — does not get the critical examination it deserves from this organization. It is rather as if Ralph Nader's company car were a Cadillac supplied by General Motors and he were given a fee to speak on their behalf! Clearly, private linkages that are quite different from those found in North America, and that do not always get the publicity this one did, can have a significant impact in creating nontariff barriers to Canadian or other agricultural exports to Japan.

While the necessary opening up and restructuring of Japanese agriculture has a long way to go, it is important to note how many inroads have been made on this once-sacrosanct territory since 1986. Resolution of disputes with the United States on 11 types of processed foods — including starch, peanuts, tomatoes, dairy products, and fruit juices — was reached in July 1987. This will end quotas on seven by early 1990 and substantially increase access, or provide compensation, on the other four. Moreover, in the spring of 1988, the difficult and politically contentious issue of reducing restrictions on citrus and beef products was resolved with the United States, despite Japanese farm protests; access has been assured, although high tariffs will be maintained.

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[3]*Asian Wall Street Journal*, June 4, 1987.

Equally unthinkable only a few years ago were the reductions in rice prices, and the willingness of the Japanese government to have the subject of the import ban raised at international talks on removing trade restrictions on farm products. As a result of this slow liberalization of agriculture, the outlook for Canadian agriculture and food exports has brightened considerably.

Construction Materials

Just as consumption of food in real terms is reduced by high prices and barriers to imports, so consumption of housing and, thus, imports of housing materials — including Canadian lumber — are restricted by land shortages, import barriers, regulations, and a weak social capital structure. Many of the historic regulations restricting land use have been overtaken by events. New materials make it possible for high-rise buildings to resist earthquakes, for example, and many of the rules restricting the blockage of other peoples' sunlight or affecting the use of land could be altered to free up sites for residential construction. Despite recent measures designed to ease the situation and curb land speculation (including the reporting and control of land transactions), it is only since early 1988 that land prices in Tokyo — which had appreciated 250 percent or more from the end of 1983 to the end of 1987 — began to ease off slightly. While some prices were off 20–30 percent, the average is closer to 5 percent, with no change in the heart of the city and with 10 percent declines being typical in the suburbs.

The subject of land prices is a fascinating one. The price of land at the most valuable intersection in the Ginza shopping district, for example, is U.S.$40,000 a square foot. Residential land in Tokyo is estimated to cost 15 times that in Frankfurt, West Germany. The value of all land in Japan is put at U.S.$1,200 trillion, two-and-a-half times what it would cost to buy the whole United States! The grounds of the Emperor's Palace in central Tokyo alone are worth more than the entire

state of California, leading to suggestions that the Emperor be reinstalled in Kyoto, the ancient capital, the land sold, and California bought with the proceeds! Indeed, if California were part of Japan, the U.S. trade deficit would disappear and Japan would become the world's leading deficit country!

More seriously, the land shortage — which, in part, is tied to tax and other regulations favoring its being kept in "farm" use — has major ramifications because it creates a shortage of affordable housing. In turn, the cramped and inadequate nature of Japan's housing stock curtails consumption of clothing, durables, and other goods, since there are not enough cupboards for storage nor is there adequate space for use and display. Nevertheless, housing outlays are moving in the right direction. Starts were 1.7 million in 1987, about the same as in the United States — which has twice Japan's population — and the third-highest in Japanese history after 1972 and 1973.

Nevertheless, more must be done to increase housing supplies. Reclaiming land in Tokyo Bay and using excess railway lands in the Tokyo region are but two rather limited and special examples. Still, it is likely that housing prices in the major metropolitan areas will continue to be much higher than those found in a typical Canadian city. The general rule in Tokyo — which is estimated to have only one-tenth the publicly accessible green space of New York — is that one pays at least twice as much for a house one-half the size of that in Canada. Moreover, the house will be more than twice as far — perhaps one-and-a-half hours by train — from one's place of work as in Canada. Until more vigorous measures are taken to deal with land use, speculation, and the protection of the Japanese sawmilling industry, trade opportunities for Canadians supplying the Japanese housing market — especially for certain types of lumber[4] — will continue to be restricted. In addition, most Japanese will continue to be unable to find affordable housing, particularly in the Tokyo metropolitan region.

[4]Canadian spruce, pine, and fir are subject to higher tariffs than hemlock from the United States.

The Distribution System

Japanese consumers have long put up with inferior housing, inadequate services, and prices for both domestic and foreign goods that no customer in other advanced countries would tolerate. In the past, Japanese producers have tended, through implicit or explicit cartel arrangements, to maintain prices in the domestic market to fund their export drives. Higher prices have also been the result of a labyrinthine distribution system composed of many layers of wholesalers and subwholesalers. By virtue of long-established relations with their customers and the appropriate provision of credit and after-market service, these distributors manage to prevent other, lower-priced competitors from gaining a foothold in the business. Moreover, many of their customers in the retail or small wholesale trade are former employees of the larger companies who remain "loyal" to their historic ties.

The trading companies sometimes attempt to force their exports on those who seek to use their services to sell in Japan, or will only reluctantly add foreign lines that compete with their domestic suppliers. This situation is now beginning to open up, however, and new competition is appearing. Some businessmen from the newly industrializing countries, for example, are setting up their own distribution companies in order to penetrate the Japanese market more effectively.

The pressures of competition are thus beginning to be felt at last in the Japanese distribution system. Returning Japanese travelers load themselves down with both Japanese and foreign goods that they can purchase outside the country at substantially lower prices. At home, the *shinjin rui* — the "new human race", as the Japanese equivalent of yuppies are satirically called — eagerly try out the latest fashions and goods from Rome, New York, or Hong Kong. In search of novelty and uniqueness, they are the very antithesis to the traditional Japanese resistance to all things foreign while remaining, like all Japanese, very demanding of quality. The fact remains, however, that consumers are too "patient" with high

prices, although this patience is increasingly eroding. A study by Japan's Economic Planning Agency, for example, found prices in Tokyo to be some 30 percent above those in the United States two years ago and the gap has probably widened since. Japanese GNP per capita is now more than U.S.$20,000 — 10 percent more than that of the United States. Yet, in real terms, it buys one-third less.

High prices, protected distribution systems — large stores have to get the permission of their smaller neighborhood competitors before they can open — and inefficient wholesale and retail trades combine to reduce both total consumption and the share of spending that goes to foreign goods and services. While the old system is breaking down, it still acts as a barrier to more Canadian exports, especially of consumer goods. Exporters of capital goods do not face these barriers, although they must still contend with the close links Japanese businessmen normally forge with local suppliers.

Public Trade Barriers

Private barriers to trade are matched by public ones. Some of the more domestically oriented government departments are openly protectionist, despite the pressures placed on them by the more internationally minded agencies, such as the Ministry of Finance, the Ministry of Foreign Affairs, and the Ministry of International Trade and Industry (MITI). Among the most protectionist departments, naturally, are agriculture, public works — which, as in most countries, is not entirely free of considerations of local political patronage — and the Department of Education — which vigorously resists purchasing non-Japanese goods, including Canadian library software systems.

Protectionism in many Japanese government departments is intensified by the links between civil service and industry. Industry and government work together and keep each other better informed than is the case in Canada. Moreover, it is not uncommon for senior officials of ministries to retire from

government between age 50 and 55 to take a senior position in the industry or industry association[5] with which they have been dealing while in the public service. Clearly, one's post-retirement prospects are enhanced by sympathetic understanding of the domestic industry's position and ensuring that business is directed to it rather than to foreigners is one way to demonstrate that sympathy.

These protection-promoting links between industry and the civil service have been stronger because of the absence — until recent times, at least — of firm political control of public servants. Traditionally, Japanese politicians have involved themselves with local and electoral issues, leaving policy and the broad direction of strategy to career bureaucrats. Prime Minister Nakasone changed this traditional arrangement during his term of office from 1982 to 1987, and began to assert firm control over the public service in those areas where international considerations and Japan's world standing and prestige were involved. Indeed, the governing party — the LDP — has established a policy committee whose growing influence and expertise is enabling it to compete effectively with the bureaucrats in policy formulation.

Many people expected Mr. Nakasone's successor as prime minister, Mr. Takeshita — a traditional, factional politician — to return to the old ways. He has, however, surprised the doubters so far. He has had considerable international experience as Minister of Finance, and is aware that Japan's economic and political well-being depends on its adapting a more open and cooperative attitude toward other members of the G-7, and most critically the United States. In this, he has the support of a growing number of sophisticated and internationally minded senior civil servants in the economic and foreign affairs ministries. International issues, too, by the sheer force

[5]Industry associations, although prolific in Canada, flourish with particular vigor in Japan, both because members of an industry tend to work more closely together there and because they are the prime channel of government-industry cooperation and information interchange.

of their growing importance, increasingly will come to outweigh shorter-term or more parochial interests.

Mr. Takeshita's style is less controversial and more consensual than that of Mr. Nakasone, who had to be unusually forceful and outspoken to change entrenched practices. Mr. Takeshita, however, by being more "Japanese" in his methods and more manipulative of the many conflicting forces at work, may be even more effective than his distinguished predecessor in opening up the Japanese economy.

This partial list of the formidable obstacles to trade with Japan is not intended to cast a pall over the proposals for Canadian exports to that country. Rather, its purpose is to underline that there are domestic forces at work to weaken or eliminate these restrictions in some instances. It is also meant to point out that those remaining can be overcome with patience, persistence, and, above all, the investment of time and effort to understand the Japanese market and how it really works.

Import-Promoting Policies

There are a number of trade-promoting elements in Japan's restructuring efforts, including deregulation, tax reform, and changes to the savings system. The latter two should stimulate consumption and, thus, spending on imports. They should also reduce Japan's extremely high personal savings rate, which is currently running at about 16 percent of income — virtually double the present Canadian rate of about 8 percent. (The U.S. savings rate in the 1970s was also around 8 percent, although more recently it has been around 4 percent; it actually fell below 3 percent in a number of quarters, but is now rising again toward the 5 percent level.)

The consequence of the high Japanese savings rate is that each household has about one-and-a-half times its annual income in savings. This is partly the result of Japanese savings having been tax free to the extent of some 70 percent. However, it is also due in part to the earlier retirement age in Japan,

typically between 55 and 60, which creates a greater need for savings and allows a shorter time in which to build them. Also, private pension plans are not particularly generous and publicly financed ones virtually nonexistent, which means that most people are highly dependent on their own savings efforts for their postretirement standard of living. Perhaps, too, the Japanese have a greater sense of insecurity about the future than do North Americans because of historic expectations of earthquake, fire, and other natural disasters. Moreover, because education is highly valued in Japan, and the best private schools are very expensive, many households set aside large sums for the education of their children.

As of April 1, 1988, the tax system no longer reinforces these basic factors so strongly. The previous *Maruyu* system allowed tax-free interest on three accounts with maximum deposits of 3 million yen each (approximately C$30,000) in addition to a company deposit plan permitting members of the labor force one additional tax-free interest deposit of up to 5 million yen. Now, all interest earned by individuals is taxed at 20 percent, with exemptions for senior citizens and those suffering hardship. These changes are estimated to produce additional tax revenues of 1.6 trillion yen. A capital gains tax of 26 percent — 20 percent national plus 6 percent local — will be introduced as part of tax reform, although how effective it will be without a taxpayer numbering system, which is political anathema in Japan, remains to be seen. Alternatively, taxpayers can elect to pay 1 percent of any security sale. All these changes on balance may divert some savings to equities. One would expect the savings rate, however — which has been falling at about one-half of 1 percent of GNP per year — to fall further as a result of its reduced tax-attractiveness, although "target-based" saving, such as an education fund, presumably will be unaffected.

This trend toward higher consumption and more imports will be reinforced in the mid- to longer term by demographic factors. The rapid aging of the Japanese population will tend to reduce the proportion of savers to consumers, while posing

other social problems for the country. By 2000, for instance, there will be only three taxpayers per pensioner, compared with six now. Retirement policies are thus likely to change, particularly as the Japanese now have the world's longest life expectancy. These changes should further promote consumption and imports.

The Private-Sector Response to Restructuring

The Japanese government's policy of restructuring has been important in starting the reshaping of the Japanese economy. An even more critical success factor, however, has been the positive response of the private sector to that policy, and the remarkable adaptability of Japanese society when change is needed. As noted earlier, the Japanese believe in changing without shame behavior that is clearly counterproductive or inferior to another course of action. Indeed, it is an embarrassment to all if persisted in.[6]

Nowhere is this flexibility more evident than in the manufacturing sector, which accounts for about 24 percent of Japanese employment against some 20 percent in the United States. Japan has now become a world leader in production management, robotics, and quality control, and in such fields as consumer durables, certain elements of electronics, and ceramics. Despite a rise of roughly 100 percent in the yen in the past three years, this flexibility has enabled Japanese producers to remain competitive and even to increase volumes and profits in 1987. Profits, excluding those of the volatile electric utilities and oil companies, fell by 22.6 percent in 1986. In 1987, however, they rose by 34.6 percent, or by 52.2 percent if the comparison is made for the fiscal year ended March 31, 1988. In manufacturing alone, the increase was 66 percent, as strong

[6]This is why the agricultural sector, which was almost venerated in the Japanese educational and social system, has lost some of its public support as well as the cooperation it used to enjoy from manufacturers. Farmers increasingly are seen as rich, unduly sheltered from taxes, and selfish, as well as imposing an unnecessary burden on Japanese society and unwilling to make their share of needed adjustments.

domestic demand, cost-cutting measures, and recovery in the material-processing industries were boosted by supplementary gains from what the Japanese call *zaitech* — financial engineering and participation in financial markets. The outlook for fiscal year 1988 is for a further rise of 25 percent in pretax manufacturing profits.[7]

These remarkable results are being achieved by further automation, by careful attention to every element of costs, by reallocation of resources and efforts, by focusing on new high-growth products, and by shedding labor. Further aiding these cost-reduction programs has been the sharp decline in the price of imported inputs stemming from the rising yen, a factor that is, however, less likely to be important in the next two years. An increasing proportion of production has also been sourced abroad, particularly in the four "little tigers", but also in Southeast Asia — especially Thailand — and in North America. Indeed, Japan's increased exports of components and materials to its suppliers in these economies have been the principal reason for the renewed rise in its total real exports. Imports of finished goods from these countries are also rising rapidly. For instance, more than one-half of Japan's cameras, radios, and black and white television sets are now imported. Imports have not yet risen as fast as exports, however, so that Japan's surplus with these countries is increasing.

It is estimated that the proportion of output produced by Japanese manufacturing firms outside of Japan will rise from 3.5–5.0 percent today to 10–15 percent in a few years (the comparable U.S. percentage is 20–25 percent). Fujitsu, for example, a typical major Japanese firm, has announced it will triple its offshore production. Even small and medium-sized enterprises are now aggressively shifting production abroad. Despite the genuine desire of most Japanese firms to be good corporate citizens, they will face major challenges in becoming true multinationals instead of being Japanese firms that happen to

[7] "Corporate Profit Performance," *Nomura Quarterly Economic Review* 18 (August 1988): 17–18.

operate internationally. This is partly because of their difficulties with English — the language of international commerce — and with other foreign languages. It also reflects their problems in adapting flexible and innovative management systems that allow for, if not encourage, variety. Moreover, non-Japanese obviously have had little chance until now of rising to the highest levels of these companies, no matter how extensive their foreign operations.

Because of rising productivity, increasing domestic sales, and cheaper offshore purchasing and production, Japanese unit labor costs in manufacturing, expressed in local currency, have remained virtually unchanged over the past two years, despite pay increases averaging about 3 percent in 1987. In U.S. dollar terms, however, they have risen sharply because of the yen's appreciation. In contrast, because of the excellent productivity gains mentioned earlier, unit labor costs in U.S. manufacturing have fallen 3 percent over the past two years and 6.7 percent since 1982. Growing automation means, however, that direct labor costs in the best U.S. and Japanese manufacturing firms now account for only 15 percent or less of total costs.

Cost flexibility in Japan has been promoted by early retirements, by transferring employees to subsidiary or associated companies, which may be distributors or suppliers, and, in some instances, by creating new companies in which to place laid-off workers. For instance, despite the recent boom in public works and domestic demand having led to a revival of the steel industry, companies in the industry continue to diversify into fields as varied as biotechnology, leisure, real estate, and travel, with the aim of having some 50 percent of revenues coming from nonsteel activities in the medium term. Shipbuilding has halved its 1980 labor force of 75,000, while 60 percent of the sales of some of the biggest textile and fiber companies are now coming from other products, such as film for magnetic tape and carbon fibers, that are the result of their devoting over one-half of their R&D funds to such new activities.

This process of labor reallocation and adjustment is made easier in Japan by the existence of company unions, a system of pay by seniority, and a tradition of lifetime employment in the bigger companies. These "three precious treasures of Japanese industrial relations," as they have been called, are based on custom, not law, but they are always honored if at all possible. They thus produce a strong sense of loyalty and belonging in the companies to which they apply. This, in turn, leads to greater cooperation between workers and management, greater recognition by both sides that the well-being of one depends on the well-being of the other, and full acceptance of the need for change to preserve the firm's competitive position. In its full form, the system covers no more than the top 15 percent of the work force. Thirty percent are employed in establishments with 30 employees or less, where the "treasures" are almost unknown, and many of the rest work in companies with fewer than 300 employees, where the application of the system is highly variable.

This industrial structure does, however, further promote cost and labor flexibility. There is extensive reliance on subcontractors, many of which, as just noted, offer no lifetime employment and few fringe benefits to their workers. Big firms may farm out 20 percent or more of their work to these enterprises, whose pay rate is typically at least 15–20 percent lower than in the larger companies. Some of these subcontractors are small two- and three-man family operations in the back streets. Others are comparable to small or medium-sized North American firms. The most sophisticated of them — the ones in the layer immediately below the big manufacturers — are extremely well organized enterprises in which the principal firm may have a minority or even a majority interest.

The ability to adjust costs in Japanese manufacturing is further enhanced by the fact that workers receive two bonuses per year, which allows pay to be significantly altered according to the firm's performance. While there is some concern in Japan that this system is becoming more rigid, bonuses typically were the lowest they had been in many years at the time

the high-yen crisis was at its worst. In particularly hard-hit industries, bonuses may be cut severely or even eliminated altogether, as occurred in the shipbuilding industry in 1986.

Labor adjustment is further facilitated in Japan because, by law, fixed-time work contracts must be for less than a one-year period and thus cannot get seriously out of line for long with changing conditions.[8] Japanese trade unions traditionally go on a spring offensive — known as *Shunto* — at which time they make demands that they know are higher than industry will concede. They normally do not get seriously out of touch with economic reality, however, because of their concern for the viability and success of their employers.[9]

A final factor making for flexibility, competitiveness, and relatively low cost in Japanese manufacturing is the extensive and growing use of temporary, contract, and part-time help. This is true even among the bigger firms. These "non-regular employees" are not entitled to lifetime employment and other privileges, and normally are not eligible to join enterprise unions — although some are beginning to recruit them. They account for up to 40 percent of the Japanese labor force — although perhaps only for one-half or less of that number in the biggest firms — and are of major importance in smaller subcontractors and retailers. The proportion of part-time and temporary, as distinct from contract, workers is still lower than it is in Canada. Many of them are women, who, until recently, have not had the rights and privileges normally extended to men in Japanese economic life. As a result of legal, social, and demographic pressures, however, this situation is beginning to change.

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[8]Obviously, Japanese firms thus must forego the opposite opportunity to enter into what might turn out to be an unduly favorable long-term contract.

[9]The 1988 *Shunto*, for example, in which the unions demanded 6.5 to 7.5 percent increases, resulted in settlements of 4.5 to 5 percent when bonuses and overtime are taken into account, compared with 3.6 percent a year earlier (see *Economic Eye* [Japan Institute for Social and Economic Affairs], August 1988, p. 2).

The quick response to the high-yen crisis, inherent labor-cost flexibilities, and cooperation between all segments of society to promote change have caused Japanese unemployment rates to drop to well below 3 percent, after briefly rising above that level.[10] This low rate is likely to be maintained, as overtime is up and the ratio of job offers to applicants is at a record high. Moreover, increased offshore sourcing, which could cost 1.2 million more jobs, would be more than offset by the impact on employment of the spread of the five-day week. The average number of hours of work per year in Japan has fallen from 2,160 two years ago to 2,110 now, and a typical work week is five-and-a-half days. This is still very high, however, when compared with the average of 1,900 hours per year in the United States, about 1,600 in West Germany, and Japan's own goal of 1,800 by 1992. The five-day week is becoming more common for bigger companies and, of course, promotes consumption, leisure, and trade. Strong public and private pressures are needed, however, to encourage people to work shorter hours and take more holidays. The reasons given for this run from company and peer group loyalty to inadequate housing and recreation facilities through to subtle hints of employer displeasure at employee absences.

In summary, the changes occurring in the private sector in Japan, particularly in manufacturing, are encouraging both economic growth and increased imports, thereby creating enhanced opportunities for Canada's exporters. Japan will remain the leading manufacturing center in the Pacific region, but it will increasingly organize these activities on a regional and even a global basis. Labor-intensive and resource-absorbing manufacturing will tend to be subcontracted or carried on outside Japan. The information-intensive, sophisticated, and high value-added activities will take place onshore, where management and a highly skilled, educated, cooperative, and organized labor force give Japan a comparative advantage *vis-à-vis* much of the industrial world.

[10]As noted in the footnotes to Chapter 2, the Japanese rate should be roughly doubled to be made comparable to that of Canada.

The Role of MITI

The activities of the private sector doubtless will continue to be closely monitored and encouraged by the Ministry of International Trade and Industry. MITI is an influential agency, but by no means all-powerful or always right. In fact, in the words of one senior Japanese banker, MITI is "like a weather man," right about half the time. It is unusually good at self-promotion and at reminding people of those of its predictions that prove accurate. Although the view of MITI as the infallible guiding hand behind all Japanese business decisions is wrong, it nevertheless plays a valuable role in the formation of broad policy, in building consensus about the direction of events and the appropriate reaction to them, and in promoting measures to ensure that Japanese industry remains competitive.

Like industry ministries elsewhere, MITI tries to develop a general view — called a "vision" — of where the economy is heading and of the conditions under which industry will have to operate. Its thinking doubtless contributed to that of the members of the Mayekawa task force and to its recommendations designed both to restructure the Japanese economy and to promote more balanced Japanese growth.

MITI sees a major part of its role as working together with the private sector, especially through trade associations and advisory committees that enable both the private and public sectors to be better informed about general conditions and each other's point of view. MITI's influence is enhanced by these wide contacts and by its understanding of what is going on in the economy.

The influence of MITI is reinforced by its administration of many of the regulations, incentives, and research and development programs affecting Japanese industry. It would be a mistake, however, to conclude that these programs are the principal reason for the success of Japanese industry. Government research and cooperative industry programs tend to be measured in the tens of millions of dollars — occasionally in

the hundreds of millions — rather than in the billions that are often found in the United States. About 80 percent of Japanese R&D is actually carried out in the corporate sector — a much higher percentage than in Canada — and all leading Japanese companies see investment in R&D as a major factor in creating and maintaining competitive advantage.

As the Japanese economy becomes less regulated and more competitive, MITI's power of "administrative guidance," which was never as great as either its critics or its admirers pretended,[11] is steadily weakening. A widely reported illustration was the reaction to MITI's suggestion in 1987, when demand picked up under the influence of strong growth at home and abroad, that the steel industry reactivate idle facilities. The industry refused, on the grounds that the facilities were high cost and, thus, uncompetitive in the long term, and it imported the extra tonnage instead. Despite its diminished power to command events, however, MITI continues to have a major role as a clearing house of information, as a market-reinforcing agency, as a department that now encourages imports as well as exports, and as a center of thought about industrial and economic trends in Japan and the wider world.

One important consequence of these trends is that MITI has come to play an increasing role in trying to curb the excesses of Japanese industry in dumping or in predatory pricing in overseas markets. MITI recognizes that such abuses are shortsighted, and that they quickly redound to Japan's disadvantage through retaliatory measures such as the tariff barriers the United States imposed on Japanese semiconductors. In general, then, MITI's major role is a positive one: encouraging sensible and outward-looking behavior, innovation, adjustment, and the creation of new job opportunities.

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[11]This power was at its zenith in the days when foreign exchange and investment controls gave MITI strong sanctions to wield in support of its views; this power was certainly used to shape the Japanese economy in the first 10 to 20 years of the postwar era.

Summary

Protectionist forces and significant nontariff barriers still exist in both the public and private sectors in Japan. But they are gradually succumbing to competitive realities, the increasing internationalization of the Japanese economy, the growing awareness and sophistication of the Japanese consumer, and the emergence of Japan as a world leader. When these trends are combined with the continued vigorous growth of the Japanese economy, one can only conclude that the background for more trade, investment flows, and technology exchanges with Canada is a highly favorable one. Whether Canadians will seize fully the resulting opportunities is the question to which this *Observation* now turns.

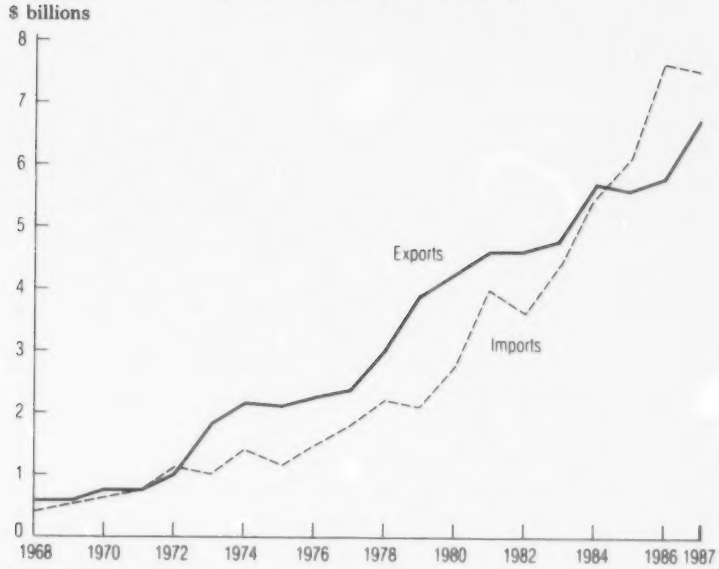
4

Prospects for Trade, Investment, and Technology Exchanges

A major aim of this study — in addition to making Canadians aware of some of the main trends in the Japanese economy — is to sketch in some of the broad prospects for trade, investment, and technology exchanges between the two countries. Previous chapters' having established that the Japanese economic background is surprisingly strong, given the yen's substantial appreciation, this chapter now focuses on the outlook for expanded commercial contacts between Canada and Japan. It is not intended to be a forecast. Rather, it is an outline of the opportunities that individual Canadian enterprises should be able to seize in the years ahead. The final chapter suggests some of the policy implications flowing from this background and outlook.

Figure 1 shows the trend in Canadian-Japanese trade over the past 20 years. While the total has grown vigorously, and Japan has moved from third to second place among Canada's customers, overtaking the United Kingdom, imports from Japan grew even more rapidly from 1977 to 1986. Thus, Canada's traditional surplus with Japan gave way in 1985 to a deficit, which peaked at C$1.8 billion in 1986. Because of the measures Japan took to stimulate domestic demand and open up its economy, and because of the renewed global growth and resulting rise in commodity prices to which these measures contributed, there was a sharp rise of Canadian exports in 1987. This shrank Canada's trade deficit with Japan by some C$1 billion as imports from Japan leveled off and actually recorded a fall of 1 percent. Continued growth in Canadian exports in the first half of 1988 has eliminated this deficit

Figure 1
Canada's Merchandise Trade with Japan, 1968–87
(balance of payments basis)



Source: *Bank of Canada Review*, various issues.

entirely. Indeed, Canada, which is now Japan's eighth-largest customer, is the only G-7 country currently running a trade surplus with Japan.

Canada's exports to Japan, as Table 1 shows, traditionally have consisted of relatively unprocessed resource products, with coal, fish, mineral, and forest products being predominant. The impact and aftermath of the 1981–82 recession on commodity markets and prices seriously affected values and volumes of metal, mineral, and forest products. More recently, the reorientation of the Japanese economy has tended to boost sales of lumber, fish, and manufactured products. Longer-term prospects for such products continue to be excellent, while those for use by the heavier industries such as steel — which

Table 1
Composition of Canada's Merchandise Trade with Japan, 1968, 1978, and 1987
(customs basis)

	Value ($ millions)			Percent		
	1968	1978	1987	1968	1978	1987
Exports						
Food, feed, etc.	$125	$ 768	$1,201	20.6%	25.1%	17.0%
Crude materials	271	1,356	2,818	44.6	44.3	39.8
Coal	15	562	1,188	2.4	18.4	16.8
Metal ore, concrete, scrap	192	410	806	31.5	13.4	11.4
Fabricated materials	195	858	2,673	32.0	28.0	37.8
Lumber	42	231	835	6.9	7.6	11.8
Wood pulp	50	198	739	8.2	6.5	10.4
End products	14	64	343	2.4	2.1	4.9
Total exports	*608*	*3,062*	*7,074*	*100.0*	*100.0*	*100.0*
Imports						
Food, feed, etc.	11	51	74	2.9	2.2	1.0
Crude materials	1	7	23	0.2	0.3	0.3
Fabricated materials	110	444	636	30.5	19.6	8.4
End products	235	1,745	6,760	65.3	76.9	89.5
Passenger cars	22	455	2,361	6.1	20.0	31.3
Telecommunications equipment[a]	47	345	1,010	13.1	15.2	13.4
Total imports	*360*	*2,268*	*7,551*	*100.0*	*100.0*	*100.0*

[a]Includes radios, televisions, phonographs, and related items.

Sources: Statistics Canada, *Summary of Canadian International Trade*, Cat. no. 65-001, various issues; idem, *Trade of Canada*, Cat. no. 65-201, various issues; idem, *Exports: Merchandise Trade*, Cat. no. 65-202, various issues; and idem, *Imports: Merchandise Trade*, Cat. no. 65-203, various issues.

will play a lesser role in future Japanese business — are less favorable.

Japanese imports to Canada are concentrated largely in consumer durables — especially audiovisual equipment and cars — office equipment, and electronic components. The sharp rise in these three categories had been responsible for the emergence of a surplus on the Japanese side of the accounts, even though these Japanese exports to Canada are not disproportionately large — being one-fifteenth those to the United States.

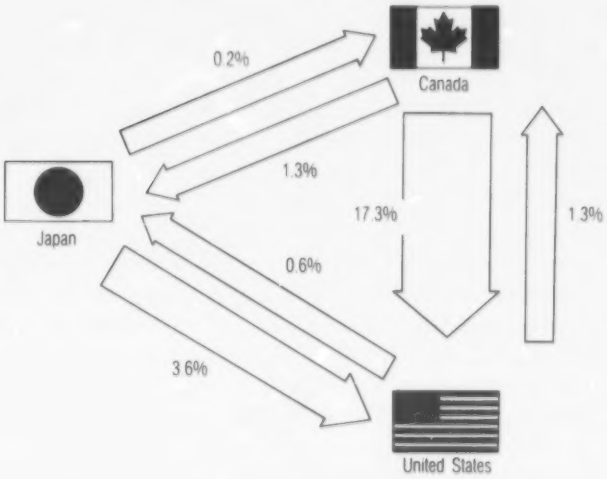
In recent years, the share of manufactured goods in Canadian exports to Japan has been rising. This is the result of more focused efforts by exporters — encouraged by government — to take advantage of the opportunities in the sector. Nevertheless, fully manufactured goods accounted for only 5 percent of Canada's exports to Japan in 1987, up from 2 percent a decade earlier. The percentage is somewhat understated by classification problems. There has been a clear tendency for much more fully processed fish, potatoes, and other agricultural products, for example, to be sold in the Japanese market.

Canada has not, however, made as many inroads in the Japanese market as have some other countries, including Australia in the resource field and many of the European countries in manufacturing. This is partly because Canadian exporters tend to be drawn to the bigger, closer, and easier U.S. market, which, as Figure 2 shows, is 13 times more important to Canada than is Japan.

The main reason for this relative lack of success, though, is that Canadian exporters generally have not put in the sustained effort necessary to be effective in the Japanese market. To succeed there, it is crucial to understand the specific price, quality, and product requirements of the Japanese customer. It is also crucial to build a relationship of trust and mutual interest. Many Canadians have not been prepared to invest the necessary time, money, and effort, but those who have done so have found the reward well worthwhile. Relationships with the Japanese are not easily made, but they are not easily broken either, and they will be increasingly valuable in the more open and vigorously growing Japanese domestic economy.

The improved quality and aggressiveness of Canadian manufacturers in recent years, reinforced by the favorable comments of the Kanao mission, have done much to open Japanese doors to Canadian manufacturers. The major efforts of the Canadian embassy staff in Japan have also contributed significantly to this process.

Figure 2
Exports Among Canada, Japan, and the United States, 1987
(as a percentage of exporting country's GDP)



Sources: International Monetary Fund, *Direction of Trade Statistics Yearbook 1988* (Washington, D.C.: IMF, 1988), pp. 129, 243, 406; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, July 1988, p. 176.

Trade Prospects

Japanese Exports to Canada

Most of the interesting questions about trade prospects between the two countries lie on the side of Canadian exports to Japan. Japanese exports to Canada are not likely to be significantly adversely affected by the Canada-U.S. Free Trade Agreement, despite the strengthened competitive position of Canadian industry. However, while the conditions facing Japanese plants in the Canadian auto industry are no less favorable than they were before the deal was entered into, a

number of other factors, discussed below, are likely to reduce the growth of Japanese automotive trade with Canada.

The Free Trade Agreement will give extra impetus to Canada's already rapid growth — its GNP expansion has recently been higher than that of any other leading industrial country except Japan itself. The Canadian dollar will continue to rise as the terms of trade for Canadian products improve. Both of these trends will have the effect of sucking in additional imports. This should create opportunities for a fairly significant expansion of Japanese manufactured goods in traditional fields such as office equipment and electronics, as well as in some of the newer value-added areas such as pharmaceuticals and biologicals, robotics, and ceramics.

Opportunities also exist to sell more financial services to Canadians, particularly if Japanese institutions become more aggressive about raising loan and equity capital for good companies that do not happen to be strong enough to have "AAA" standing.

The principal exception to this promising outlook for continued growth of Canadian purchases from Japan is likely to be automobiles. A number of factors will limit the growth of these imports. First, there is the shift in currency values between Japan and North America. Second, a number of new Japanese plants have been or will be constructed in Canada. Third, competition is increasing from other Pacific car makers. Fourth, there is growing overcapacity in the North American industry — partly because of Japanese plants being built in the United States for political as well as economic reasons. On the other hand, imports of Japanese-made parts and components for sale to the new plants, and to the growing aftermarket, should show a significant increase.

Under the Free Trade Agreement, production-related duty remissions will end in 1989 and export-related drawbacks will terminate not later than 1996. U.S. objections to these remissions have been intense, and the Canadian negotiators did well to achieve what they did. This particularly so as they succeeded in maintaining "safeguards" on Canadian production and

content — which have not been necessary for some time — as a protection against future unfavorable developments and present political exigencies. No new firms, however, will be allowed to qualify for auto pact status after 1989, and those firms that now qualify will have to achieve a 50 percent North American manufacturing content to obtain duty-free entry — effectively an increase from the previous 60 percent value-added content. No Japanese firm previously qualified, and none was likely to do so in the foreseeable future. The joint venture between Suzuki and General Motors has been granted auto pact status if it can meet the manufacturing content requirement. All existing duty remission deals will be honored until the previously agreed expiration dates. If Japanese auto firms in Canada wish to remedy their inability to import parts duty free when present export-related remission schemes end, they can do so in the same way as before: by getting the Japanese government to negotiate elimination of the Canadian tariff on imported cars and parts — currently 9 percent — or its reduction to at least the U.S. level.

Canada and Japan might also agree to remove "voluntary restraint arrangements" on automobiles, since they are not now limiting imports into Canada. When such imports were limited, the impact of these restraints was that, in 1985, the Canadian consumer paid at least C$739 more for each domestic car and C$888 more for each Japanese car.[1] This is even assuming Canadian car makers did not move their prices up with those of Japanese importers, who were able to exploit the limited supply situation the quotas provoked, which is a dubious assumption. Impact of such restraints in stimulating domestic production and employment has been described as "modest at best."[2] Canada thus could do both its own consumers and the Japanese industry a favor in the long term by eliminating these trade restraints. The resulting signal might also

[1]Organisation for Economic Co-operation and Development, *The Costs of Restricting Imports: The Automobile Industry* (Paris: OECD, 1988).
[2]Ibid.

accelerate the trend to more competitive behavior on the part of both labor and management in the North American auto industry.

Such quotas in the exporting country not only encourage the industry to raise prices, they also induce suppliers to move up market. Since the number of units is limited by restraints, moving up market maximizes the value of each unit. Restraints also tend to cartelize markets in the exporting country and increase the influence of government — in Japan's case, MITI — as arrangements have to be worked out to share the available quota in each country and industry concerned.

Canadian Exports to Japan

Canadian exports to Japan should not only grow rapidly, but also shift in composition. Accelerated expansion of domestic demand in a restructuring Japanese economy, rising consumer interest in foreign goods, and increasing imports of manufactures, particularly producer goods to supply the increased investment of Japanese industry in flexible manufacturing, all point to the opportunities for Canadian sales of more highly processed items. This, however, will require persistent efforts, as well as a greater investment of time and money in understanding the demands of Japanese consumers and industrial customers than many Canadian companies have thus far been willing to undertake.

The opportunities are wide ranging, running from processed food, fish, and meat products to high-technology items such as pharmaceuticals, biologicals, and sophisticated machine and other tools for industrial production. Growing linkages between Canadian auto parts suppliers and the new Japanese plants in North America should also be reflected in greater volumes of these commodities flowing to Japan. A number of Canadian auto parts companies, including Magna and Tridon, already are selling successfully into the Japanese market, and this industry's penetration should become wider and deeper over the years.

Telecommunications equipment and electronic components is another fertile field of growth, although the purchasing practices of Japanese telecommunications companies, despite improvement, still represent a formidable nontariff barrier. Northern Telecom and other companies, however, have made a worthwhile beginning. Commercial aircraft, satellite and communications equipment, and advanced petrochemical products are other illustrations of the kinds of Canadian goods that should be able to find growing markets in Japan.

Canadian exports of raw and semiprocessed materials may grow somewhat more slowly in future as a result of the shift of Japanese manufacturing away from heavy to light, more technologically intensive industries. This will affect the growth of markets for such products as coal, aluminum, and metals in concentrated form. Exceptions should be goods, such as lumber, that find their way directly or indirectly into public works and housing, and primary products that are able to compete in the Japanese market as a result of the (too slow) removal of barriers to agricultural trade. Beef exports, in particular, now should expand rather vigorously. As noted earlier, the removal of progressive U.S. tariffs against Canadian processed materials will make larger-scale and lower-cost production possible in Canada. This, in turn, should make Canadian exports of these materials more competitive in third markets such as Japan and lead to a higher proportion of natural resource-based exports in more processed form. The shift in the composition of Japanese manufacturing should also enhance these opportunities. Given all these favorable trends, Canada should aim to see at least 20 percent of its exports to Japan be in manufactured form in the medium term.

There are also possibilities for increased earnings in the services industry, including consulting on public works projects, library software, engineering, and other services to industry. Indeed, the whole field of English-language software is one in which important niches can be established in Japan. More generally, the widespread need in Japan to improve the teaching of English, particularly to those in business, offers an

opportunity for Canadians to develop and sell both live and prepackaged cassette programs.[3] In addition, there is the possibility of significantly expanding Japanese tourist spending in Canada; our space, mountains, coastlines, clean cities, and clean air all appeal to the Japanese. Considerably more could be done to build this business — even to persuade the Japanese to have second houses in British Columbia.[4]

It may be more difficult to expand Canadian exports of financial services significantly. This is because of the slow pace of deregulation and opening up access to foreign firms in Japan, the fact that financial institutions from every country in the world are anxiously seeking a share of the available business in Tokyo, and the growing competition between commercial, long-term credit banks and investment dealers there.[5] Despite the many difficulties of competing in an unfamiliar culture, the growing wealth of Japanese consumers and their interest in quality, variety, and novelty offer Canadian suppliers of services an enormous, untapped potential.

Investment Flows

Canadian investment in manufacturing in Japan is relatively small and is likely to remain so, given the high costs and relatively low returns from setting up a business in that unfamiliar and intensively competitive market in the short to medium term. However, to obtain sales, to build relationships for the longer term, and to be thoroughly competitive in Japanese markets will require investments in distribution, service, and

[3]The Japanese government is already planning to underwrite the cost of some 80 additional English-language teachers as part of a program to strengthen Canadian-Japanese relations.

[4]Some people are even promoting the idea of establishing retirement communities in Canada for Japanese senior citizens. It seems unlikely, though, that many of them would want to go so far from home, family, and their own culture at such a late stage in life.

[5]There are 30 foreigners in the Japanese government short-term bond syndicate, who share only a minority participation. Their share in the ten-year bond syndicate was raised from 2.5 percent to just under 8 percent on October 1, 1988; since that date, 40 percent of the bonds are to be sold by auction rather than by the syndicate.

support facilities. Often, these can be provided by local firms. On other occasions, a joint venture with a Japanese partner who knows the market, a direct investment, or even facilities provided on an industry-wide basis will be preferable. Some of these eventually will develop into production facilities. There will also continue to be a few large Canadian investments in Japan by major companies — in aluminum and business forms, for example. Much of whatever growth occurs, however, seems more likely to take place in services such as consulting, software distribution, and finance.

Japanese investment in Canada, in contrast, has been growing quite rapidly, although from a very small base. Amounting to C$12 billion in 1980, such investment was C$36 billion by the end of 1986. By far the largest portion of this — C$33 billion — was in the form of government bonds and loans to federal and provincial governments. The remainder was made up of portfolio equity holdings of C$0.5 billion and direct investments of C$2.2 billion.

The enormous size of annual Japanese savings flows — U.S.$242 billion in 1987 — to say nothing of accumulated stocks of past savings in liquid form amounting to trillions of dollars — means that when Japanese institutions develop some consensus on whether Canada is, or is not, a good place to invest, the impact on external capital flows can be significant. This could pose significant difficulties of interest and exchange-rate management for the Canadian authorities in the short term, especially when the longer-term views of Japanese investors are reinforced by more immediate speculative considerations about currency and/or interest-rate trends. For example, in the three years ended 1987, the largest quarterly Japanese inflow of capital amounted to C$5.6 billion, while the smallest was C$334 million, a variation of C$5.3 billion. On one day alone in early 1987, Japanese investors, having decided that the Canadian dollar was overvalued, sold over C$1 billion on the exchange market.

Growing awareness and expertise about Canada has caused Japanese institutions to begin to increase their holdings of

good-quality Canadian corporate bonds, and even a few blue-chip stocks, particularly those — still few in number — that have their shares listed on the Tokyo Stock Exchange. Total Japanese holdings of Canadian corporate bonds increased rapidly to C$4.5 billion at mid-year 1988, up from just C$1.1 billion at the end of 1984. Japanese holdings of Canadian stocks increased by C$419 million over the same period.

Japanese direct investment in Canada is still relatively small, despite the highly publicized investments in auto plants and parts facilities by companies such as Toyota, Honda, and Suzuki. The estimated total of such investment in 1987 amounted to only C$2.5 billion; the inflow in 1987 was approximately C$300 million, down somewhat from that in 1986, and amounting to only 1 percent of Japan's total direct investments abroad of U.S.$33.4 billion in 1987. By comparison, Japanese direct investment in the United States amounted to a still modest U.S.$30 billion by the end of 1987. The Canadian figure is also smaller, relatively, than that invested in newly industrialized countries such as Taiwan and South Korea. In such countries, as noted earlier, Japanese industries are carrying out increasing amounts of component manufacturing, subassembly, and subcontracting. Nevertheless, there is a reasonable prospect that Japan will become the second-largest investor in Canada in the early 1990s, although its total will be nowhere near the more than C$75 billion that the United States has invested here.

In general, Japanese industrialists do not see Canada as the priority country for North American investment. To them, the U.S. market is the one in which they normally seek first to be represented. Many Japanese also have a lingering perception of Canada as being somewhat hostile to foreign investment because of the nationalist and unwelcoming policies of the Foreign Investment Review Agency in the late 1970s and early 1980s. The coming into being of Investment Canada in mid-1985, the generally more favorable climate for enterprise in Canada, and the Kanao mission's favorable report in 1986 do not yet appear to have been fully appreciated by the

Japanese business community. Nevertheless, there is growing awareness of the positive impact of the Canada-U.S. Free Trade Agreement on Canadian incomes and competitiveness — and not just on the trade between the two countries, which is now approaching C$200 billion. Canada's favorable exchange rate and relatively low wage, materials, and manufacturing costs are also better known in Japan. There is, however, little Japanese awareness of how the Free Trade Agreement, by offering secure access to the U.S. market, will enable Canadian manufacturers to lower costs drastically as they begin to enjoy the full economies of worldscale operations.

The majority of Japan's direct investment in Canada remains connected to the resources industries, particularly the energy, forest, and metals industries, to the distribution and trading of Japanese products, and, especially in recent years, to banking and finance. Much of the resource investment was to assure a continuing supply of raw materials to Japanese users at a time of apparent shortage. Latterly, although the focus has been increasingly on investments in manufacturing, largely related directly or indirectly to the automotive industry, this sector still represents only about one-third of the total. Many of these are joint ventures established under the aegis of Pacific Automotive Cooperation Inc., established in 1984 by 11 Japanese auto makers and a major auto parts manufacturer. The organization's aim is to encourage both investment and technology transfers by acting as an intermediary between suppliers to the Canadian and Japanese automotive industries. About 20 projects have been announced under this program since mid-1984, including a dozen joint ventures covering materials as well as parts.

Joint ventures between Canadians and Japanese, however, have covered a wide range of high-technology products and systems. These include the manufacture of floppy disks, the production of robots with a vision system developed at the National Research Council, research into antibiotics, development of anticancer drugs, and production of vaccines. These illustrations are just a few of the growing number of associa-

tions between Japanese companies and their Canadian counterparts. The number of Japanese companies in Canada is growing rapidly. In the Metropolitan Toronto region alone, there are now about 160 of them. Much of their investment is in the form of representative offices and sales, service, and distribution centers, but their presence enhances the already substantial prospects for growing Japanese investment in this country.

Joint Ventures in Technology

There is a great potential for Japanese and Canadian firms to work together on research and development, on technological and product improvement, and on the transfer of existing technology from one country to the other. Many people think of Japan as being a technological leader, and indeed it is — but only in a limited number of fields and specialities. In fact, Japan is a heavy user of, and quite highly dependent on, U.S. technology, although it is often able to improve it or adapt it to its own uses. One indication of this dependence is that U.S. license fees to Japan are more than three times those of Japanese licenses to the United States.

More than 13,000 Japanese study science and technology in the United States, almost 20 times the number of Americans doing the same in Japan. This is partly because Americans do not have the familiarity with the language that Japanese scientists do with English. It is also partly because of the Japanese lack of foreign scholarships, foundation grants, and tax incentives comparable to those available to foreign students studying in the United States. Japan is now paying for some 200 U.S. students to go to such schools in Japan, and U.S. universities increasingly are opening campuses in that country. But cramped personal and office quarters, expensive living costs, and considerations of industrial security, among other factors, tend to discourage North American researchers from going to Japan.

While the more parochial attitudes of North Americans may be an important element in limiting R&D exchanges with Japan, another important factor is that less than 20 percent of R&D in Japan is performed by government. The image of huge government direct expenditures on, and subsidies to, research is largely a myth. Similarly, Japanese universities do little research, although the situation is changing. Thus, almost 80 percent of research is performed in industry. While making for the fast diffusion of new technology in industry, this situation often restricts broad exchanges of personnel and students because of competitive considerations.

Because only a tiny fraction of research in Japan is done in the universities, reflecting their sometimes limited physical facilities and mentally confining atmospheres, many leading Japanese scholars go to foreign universities, particularly in the United States. Such institutions provide better facilities and greater stimulus and encouragement to innovative thinking and creativity. Thus, for example, two of Japan's Nobel laureates have done essentially all their award-winning work in the United States.

Given this background, and the excellent university and private R&D facilities that exist in Canada, the scope for Japanese and Canadian enterprises to work together to develop technology and to advance R&D is considerable. Certain authors, notably Robert Reich,[6] have warned about the dangers of entering into joint ventures with Japanese firms. They allege, in effect, that the technology will immediately be transferred to Japan and the joint venture then abandoned. Nevertheless, this danger, which exists in any joint venture, seems exaggerated, particularly if appropriate conditions, safeguards, and sanctions are negotiated initially. Wider use of joint ventures will certainly require more open and cooperative attitudes on both sides. Yet, such internationally coordinated technological ventures increasingly will be required. Many research projects are now becoming so large — and need

[6]Robert Reich and Eric D. Mankin, "Joint Ventures with Japan Give Away Our Future," *Harvard Business Review* (March-April 1986), pp. 78-86.

so many different points of view and so many varied centers of expertise to ensure their success — that they cannot be based in any one company, one research center, or even one country.

The need to improve the coordination of its research internationally will be reinforced as far as Japan is concerned by continuing expansion of its expenditures on defense. On a comparable NATO basis, these outlays now amount to some U.S.$40 billion a year, third in the world after the United States and the Soviet Union. In contrast to some Western countries, an increasing proportion of these rising defense expenditures, which equal about 1.5 percent of Japanese GNP, is being spent on technologically advanced hardware and equipment, which has a high R&D content. Some of Canada's special skills in defense-related fields would make it a natural partner for joint R&D and technology programs in this area.

Canada's strengths in biotechnology, medicine, vaccines, polymers, satellites, remote sensing, miniature submarines, software, and telecommunications — to name just a few — suggest some of the possibilities for joint licensing and/or technological ventures. Indeed, as noted earlier, a number of projects already exist in these areas, as well as in the fields of electronics, automation, and materials. Such partnerships offer substantial mutual advantages. The talents of some Canadians for innovation, creativity, and problem solving would mesh naturally with Japanese skills at improving processes, transferring technology to industry, and putting the fruits of R&D into practical and efficient production.

Beyond these possibilities for commercial links, Canadian universities — with their open spirit and outward-looking attitudes — ought to be able to offer excellent value to their Japanese counterparts in a whole range of academic exchanges between the two countries.

Summary

There is a rich variety of opportunities for Canadians to establish and expand trade links with Japan. They exist in manufactured goods for both industry and consumers. They are also present in investment projects in Canada, particularly those also designed to serve the U.S. market, where Canadians can use their familiarity with that country's customers to mutual advantage. In technology and R&D ventures, Japan's production and product commercialization skills can be combined with Canada's growing skills in technology, innovation, and the information-intensive industries.

5

Prospects, Policies, and Conclusions

Making the Relationship Work

A number of factors have come together to create an environment of unequalled opportunity to increase trade, investment, and — perhaps especially — technology and research exchanges between Canada and Japan.

On the Japanese side, there has been excellent progress since 1986 toward basing continuing vigorous economic growth on domestic, rather than export, demand. The Japanese have made a successful, if unduly slow, start to restructuring and opening up the backward sectors of their economy. They are also taking needed, albeit somewhat tentative, steps to eliminate private and public trade restrictions.

On Canada's side, a major factor is the vigor of its economy. In addition, Canadians are becoming increasingly aware of the opportunities offered by Pacific Rim countries in general and Japan in particular. Finally, the conclusion of the Free Trade Agreement with the United States has created extra possibilities of stronger Canadian growth and competitiveness.

To take full advantage of this favorable potential, however, the Canadian private sector must work harder at cracking the Japanese market and be prepared to invest more time and effort in the process. In particular, Canadian manufacturers will have to keep working at improving their quality and productivity,[1] and at seeking out and building those lasting relationships that are so vital in Japan. While government officials can help — in particular, by providing useful contacts and valu-

[1]The growth of Canadian manufacturing productivity since 1980, at 2.3 percent annually, has not kept up with that in the United States and has been among the lowest of the OECD countries. Since mid-1987, however, there has been an encouraging indication of improvement.

able advice — they can only supplement, not substitute for, strong marketing, vigorous sales efforts, and a persistent focus on the customer's desires.

The Canadian private sector also needs to be more aggressive in selling the many opportunities for Japanese investment in Canada and in explaining how the climate has changed since 1984. Government salesmanship is all very well, but the story is more convincing coming from business and labor. Finally, on the Canadian side, there needs to be more stress on the growth and potential of the technologically and information-intensive, value-added and advanced sectors of Canadian manufacturing, which the Free Trade Agreement will further accelerate. This growth creates a vast potential for joint ventures and research and technology partnerships.

On Japan's side, no lessons need to be given about aggressively taking advantage of the potential for increased sales created by Canada's strong growth. The Japanese do need to have a greater appreciation, however, of the constructive nature of the Free Trade Agreement, of the reinforcing effect it will have on the growth of Canada's value-added industries, and of the opportunities it offers for closer commercial links between the two countries.

In each country, the public and private sectors will have to work together to eliminate private and public nontariff barriers in the other. In this area, Canadian exporters will find the Canadian embassy staff in Tokyo particularly helpful. Its excellent standing with the major Japanese economic ministries — including MITI, which now has a role in promoting the internationalization of the Japanese economy in addition to its other duties — can often result in effective action. As noted earlier, these nontariff barriers, though diminishing, are still very pervasive in Japan, especially among the conservative — that is, xenophobic — domestic departments of the Japanese government. The Canadian embassy's contacts and awareness of how the system works are particularly valuable in breaking down such public-sector resistance to more open and competitive trade.

Japan, like Canada, will only reduce its nontariff barriers if it is convinced that this is in its interests. Thus, Canadian exporters must make their arguments vigorously and continuously, on the basis of the cost savings, quality, and service they can provide to their Japanese customers, especially in the longer term. As has already been stressed, Japanese in both the private and public sectors set great stock on the continuing and dependable nature of relationships. Thus, the most successful negotiations will always be with those whom they have come to know to be reliable, trustworthy, and sensitive to their interests and needs as well as forceful and effective in putting forward their own.

It is vital for global well-being, as well as for Canada's narrower trade interests, to disarm protectionist sentiment by dismantling private and public barriers to trade. It is also critical, however, for governments and private interests alike to avoid unconstructive "Japan-bashing." Admittedly, some attempts at protectionism in Japan have verged on the ridiculous. For example, the Japanese ski industry once claimed that snow in Japan was "different," and the medical instruments lobby suggested that Japanese bodies were so unique that U.S. medical instruments could not be used on them. Nevertheless, public rhetoric and demonstrations of appliance smashing on congressional lawns are not the recommended ways to improve Japan's international behavior. Canada, fortunately, generally has avoided this type of unconstructive criticism, and its standing in Japan is high as a result.

Yet, it must be admitted that some Japanese cry "Japan-basher" at the first sign of any forceful objection to Japanese protectionist abuses. Since Japanese policy can be as shortsighted, as uncooperative, and as responsive to narrow vested interests as that of any other country — perhaps more so, given Japan's national capacity to believe that its people and situation are somehow uniquely different — its trading partners frequently have a strong case against Japan.

To be effective with the Japanese, the arguments against such protectionism must be forcefully and reasonably presented.

Since the Japanese — even more than most people — do not like to be embarrassed, or to embarrass their opposite numbers, they will normally seek a reasonable way to avoid doing so if one exists. Nevertheless, tenacity in pursuing the case is also essential, since the Japanese negotiating style frequently involves a patient and unbending stance. Lack of determination, or failure to persist in pushing one's reasoning, however time-consuming the process, is a sure way to lose an argument with the Japanese. The U.S. reaction in such circumstances usually has been to react very forcibly, using retaliation or threats to obtain results in the face of Japanese inaction or superficial gestures. While often adding to Japanese hostility, this approach seems finally to have convinced Japan that the Americans were serious. Sensible responses by the Japanese, in turn, have persuaded the Americans to be more sensitive to Japan's very real political difficulties in some areas, such as agriculture. Thus, the United States did not follow up the beef and citrus settlement with further demands on rice, agreeing to leave that issue to be resolved in an international forum.[2]

While Canada's trade-negotiating style, as former Minister for International Trade Patricia Carney observed, is to be polite in public and "tough in private," it, too, must continue to press Japan to remove remaining trade barriers. This is not just because they are costly and unnecessary irritants to the two countries' trade, but because they are seen as confirmation by protectionists everywhere that Japan does not act in good faith and, thus, that still more protectionism is justified in response. Canada must press this point. Japan needs to be

[2]Subsequently, U.S. rice millers, seeking to take advantage of the U.S. election situation, launched a complaint against Japan's rice policies on the grounds that they contravene U.S. and international trade laws. Since this is almost certainly true, the U.S. authorities were forced to take action, which aroused a strong political reaction in Japan — the Japanese having felt that an earlier understanding had been breached. This, in turn, provoked U.S. anger at what seemed like Japanese intransigence. The net result has been damage to the bilateral relationship, and a possible setback to the chances of solving the rice problem.

reminded that, as one of the world's leading and richest powers, it has a special responsibility not to take shortsighted measures that jeopardize global economic stability. Reminders of this sort are, in fact, very helpful to the more internationally minded Japanese in both the public and private sectors, since they can use them to good effect with their more parochial colleagues at home.

Promoting the Right Macroeconomic Policies

Canada perhaps still has an influence on international events out of proportion to its size, although not as great as it sometimes likes to think and certainly less than it was in the decade following the Second World War. It must use this leadership influence where it can to promote sensible, balanced international economic cooperation. Balance does not mean that Japan, the United States, and other members of the Group of Seven should follow overly expansive, inflationary policies to avoid the need for adjustment on the part of its least disciplined members. It does, however, mean promoting as much stable, noninflationary growth as possible in the stronger economies. Both Japan and Canada are doing their part. In the first quarter of 1988, Japanese growth and consumer price inflation at year-to-year rates of 6.7 percent and under 1 percent, respectively, and unemployment at 2.4 percent were all at very desirable levels. Canada's economic growth, at 5.3 percent, is also vigorous, but its inflation-unemployment tradeoff needs to be improved.[3]

In such buoyant circumstances, Canada's fiscal deficits, unlike those of Japan, should be reduced further to lessen its claim on world resources, to lower interest rates, and to free extra funds for private investment. The amount of immediate deficit adjustment called for to achieve balance gradually over a five-year period is still relatively small — about C$6 billion, or 1 percent of GNP. With initial cuts of that size and

[3]July 1988 figures show unemployment at 7.9 percent, while data for June show consumer price inflation at 3.9 percent.

moderate annual curtailments thereafter, the cumulative saving, including those on interest payments, will meet the five-year target. Electoral considerations made the practical chances of such a program occurring in 1988 even smaller. Nevertheless, continued inaction will lead to a major fiscal crisis in Canada. The new government will be forced to apply a firm dose of restraint to bring the deficit under control. This will come through restructuring, better spending controls, and a smaller and more effective pattern of social outlays.

On the Japanese side, the importance of keeping its macroeconomic policy focused on contributing to a harmonious and balanced international economic environment is now self-evident. Japan is unlikely to repeat the shortsighted and illusory promises of stimulus and restructuring it engaged in before 1986, especially since it recognizes the damage it did to its own reputation. Its present fiscal course is likely to be a durable one, as expansion will be supported by high consumer and investment spending. In part, this supportive fiscal policy will be funded by the long term increase in consumption taxes and by the proceeds of the next rounds of privatization of the world's largest telephone company, NTT. Moreover, Japan's consumers will be supportive of continuing such policies, as well as of measures needed to eliminate restrictions and protectionism. They are no longer willing to be exploited to promote the interests of narrow interest groups. Finally, a consensus has emerged in Japan on the need for investment in social capital and public works, which will raise productivity and living standards and be self-financing in the wider sense. Canada, too, would do well — particularly when temporary stimulus is called for — to focus more of its federal budget in future on promoting investment and less on increasing permanent government consumption.

Dr. Shoichiro Toyoda, head of Toyota Motor Company, said a few years ago, "Japan has to realize that, in order for it to prosper, the entire world has to prosper." Japan now also realizes that if the world is to prosper, Japan itself must play an important part in creating that prosperity. Although it still

has difficulty in perceiving itself as a world leader, its success in maintaining aggregate demand, in restructuring its economy, and in increasing imports will continue to be crucial in creating a better balanced world trade and financial position. As events in 1987 and 1988 have shown, successful Japanese policies will mean a more open global economy, higher world demand, and fewer problems in the debtor countries. The poorer of those countries would be helped, particularly if Japan used increased foreign aid — still only about 0.3 percent of its GNP — as an instrument to promote their social and economic development. It could also use such aid to promote peace and rehabilitation in previously warring regions, given that it will not wish to play a military role of any sort.

Canada must encourage Japan to play this world leader's role and to find the right balance between diffidence and assertiveness in international affairs. Canada and Japan together should also be doing all they can — through the G-7, other international organizations, and individually — to influence U.S. macroeconomic policy to bring about a better balance between consumption and investment in that country. The United States remains the world's most ingenious, inventive, and flexible society, and both Canada and Japan benefit enormously from that ingenuity in their growth and living standards.

The two countries' trade with the United States has grown much more rapidly than it has with other countries. From 1980 to 1987, Canada's merchandise exports to the United States grew by 97 percent in Canadian dollars, those to Japan grew by 59 percent, while those to the European Community actually declined by 2 percent. During the same time, Japan's exports to the United States, also measured in Canadian dollars grew by more than 200 percent, those to Canada by 162 percent, and to the European Community by 138 percent. While the growth of both countries' sales to the United States stemmed in part from the U.S. trade imbalance that developed in that period, and thus will not continue, Canada and Japan will still share the privilege of being closely tied to the world's largest and most innovative economy — and one of the most

rapidly growing. Indeed, Canada's special relationship to, and understanding of, the United States offers it the useful opportunity of serving as a mediator between Japan and the United States from time to time. It can help put Japan's legitimate concerns and point of view to the United States when — as inevitably and occasionally happens — that country unfairly blames Japan for its own shortcomings. Equally, however, Canada, as a friend of Japan, is in a good position to push it to adopt more open and stimulatory policies on those occasions when Japan is doing less than it reasonably could to meet the legitimate needs of the United States and/or to contribute to global economic balance.

The unique relationship Canada and Japan enjoy, not only with each other but also with the United States, also carries with it the responsibility to remind that country that its leadership will only be maintained if it saves and invests enough.[4] The main problem in this area is U.S. personal savings, which, despite recent increases, are still running at just over half their level of the 1970s. Whatever role U.S. government deficits may have played earlier in shouldering world demand, the low U.S. private savings rate means that the United States must now follow a more sensible fiscal course. Both Canada and Japan must apply ongoing pressure to do so. Japan, in particular, has the surplus savings available to finance a pattern of gradually reducing U.S. deficits. Canada's influence in this area is greatly weakened by its own poor fiscal example.

Microeconomic Measures to Improve Performance

While getting the major policy settings right is vital, the future of both Canada and Japan, as well as their relationship with each other, will be determined in large measure by getting microeconomic policies — which mainly affect the sup-

[4]As noted earlier, U.S. gross investment is at record levels. R&D outlays — not statistically part of investment — have also been rising rapidly, particularly in the private sector, and on a national basis have recently become a somewhat higher percentage of GNP than they are in Japan.

ply side of the equation — right as well. The list of lessons that Canada could learn from Japan in this area is extensive. First is the importance of farsighted management that is capable of looking beyond this quarter's earnings but that can deliver satisfactory results in the long-term. Second is the need to take vigorous measures to eliminate barriers to change throughout society. Third is the importance of encouraging high levels of savings and investment, in which the tax system is significant. Fourth is the vital role of cooperation between all sectors of society, particularly management and labor, in a highly competitive world. A final lesson is the importance of offering the maximum of job security, training, and career advancement in return for that cooperation.

To promote more open multilateral trade, Canada, like Japan, will have to abandon its agricultural protectionism and supply management practices in the longer term. Canada's barriers to trade in this sector are much higher than most Canadians like to admit. Producer subsidy equivalents — roughly the level of subsidy, in terms of income, that would be needed to compensate producers for removing government's current support — are close to 50 percent in Canada, 35 percent in the United States, and about 75 percent in Japan, the worst offender.[5] As noted earlier, Canada also will have to work closely with Japan and other countries to reduce protectionism in the industrial world, although its trade barriers — with the possible exception of those in some segments of the automotive industry — are not nearly as significant as those of its Pacific neighbor.

In addition, a more open multilateral world will force Canada to stop bailing out its failing industries and preserving its industrial relics in a museum of the uncompetitive. If Canada is to compete successfully in the Japanese and other major markets, the forces of adjustment in the marketplace must

[5]If Japan were to eliminate these subsidies, it might have the incidental effect of raising real wages and lowering land and housing prices. Domestic wage pressures would then be less and Japanese industry would become even more competitive.

be allowed to work more thoroughly. Encouraging investment in R&D is helpful, but, as Japan's experience shows, this need not be done through large handouts or through having the public sector undertake large amounts of research directly. Canadian government policy also needs to encourage the more rapid diffusion of modern production technology to small and medium-sized business, a process which can be greatly helped by joint ventures and research and technology agreements with Japanese firms.

On the Japanese side, microeconomic policies to promote growth must include tax reform, privatization, and deregulation, particularly in the financial sector, where useful lessons may be learned from Canada's experience. In industry, as in society generally, and especially in the universities, innovation and creativity will have to be promoted; the age of electronic information thrives on variety. Japanese firms will need to develop more flexible organizations, promote a culture where fresh ideas are valued, become truly multinational, and improve their understanding of foreign customs and languages, especially English. The distribution system, which is already changing, will have to be drastically overhauled. The remaining resistance in the bureaucracy to the forces of change and to political control will have to be sharply reduced, and the tone of political life raised, as befits a world leader. Stronger policy direction from the prime minister — which started under Mr. Nakasone — will be needed for success in these areas, particularly as many of the decisions that must be taken are politically painful. Some — like dismantling agricultural protection — will be made marginally easier by the shift of political power to more internationally minded urban voters.

It is crucial that these changes be carried out in a way that does not imperil Japanese growth or undermine those very qualities that have made Japan such a success. There is no reason why they should. The Japanese can continue to be industrious and hard working, while adopting the five-day week. Running a stable budget deficit and emphasizing social capital more and exports less is not going to turn Japan from a

cooperative to a confrontational society. Tax reform, financial deregulation, and the lowering of consumer and housing prices will not do away with the strong tendency of the Japanese to save and invest. Curtailing protection, especially for the backward sectors of the economy, will, in fact, encourage interest in research and development, even in agriculture.[6] Nor is there any reason why a shift from heavy, material-intensive goods, such as steel, to light, high-technology, knowledge-intensive goods and services such as ceramics and software, should weaken the Japanese capacity for problem solving, and for improving technology and production techniques. Finally, Japanese policies that are more international and more responsive to Japan's growing role as a world leader are, if anything, likely to enhance Japan's talents for abandoning outmoded ideas and practices that clearly do not work.

Consumption ratios doubtless will rise in Japan, as will leisure, but savings rates will not fall to the dangerously inadequate levels of those in the United States. An aging population will need even more to provide for its retirement needs. A society short of needed public facilities must set aside more funds to provide for them. But as it becomes increasingly involved with and dependent on the international economy, it must also turn its eyes, its savings, and its talents outward to trade and to the international diffusion of technology. A better balance between domestic and foreign interests will serve Japan well in the years ahead, in addition to assisting the people in the newly industrializing economies and the less-developed world.

While close cooperation between Canada and Japan can have many benefits at the level of microeconomic policy, none will be more important — for themselves and for the world — than that of cooperating in the various multilateral forums to eliminate barriers to trade. Both countries can play a constructive role in the current Uruguay Round of the General Agree-

[6]Some such research expenditure on high-technology agriculture and advanced, specialty farm products is already occurring (see "Yesterday's Farming," *The Economist*, August 20, 1988, pp. 58–59).

ment on Tariffs and Trade (GATT) to liberalize international economic arrangements, including trade in services and agriculture and codes on the treatment of investment and intellectual property. Canada is an enthusiastic supporter of the GATT in principle,[7] while Japan has indicated it will play an active role in the negotiating process and is vigorously supporting the reduction of barriers to world trade.

By showing that two quite different societies with different endowments and different heritages can benefit from closer and more open trade, investment, and technological links, and that they can use them to take better advantage of their complementary skills and economies, Canada and Japan could encourage the rest of the world to pursue more liberal policies. In the years ahead, trade between the two countries should grow more rapidly than that of each of them with the United States, despite the measures each is taking to open their markets to U.S. imports and secure or improve access for their exports in that market. Indeed, trade between them should rise as a proportion of their total foreign purchases and sales, although perhaps not as fast as their trade with the newly industrializing economies of the Pacific Rim.

Working together, Japan and Canada can help to reduce the forces of protectionism in the United States and around the world. While their bilateral influence is not likely to be major, it can be influential. This issue is vital, to them and to the rest of the world. A restrictive trading environment is not only likely to be slow growing and unstable economically, but a fertile ground for upheavals and chaos politically. In that sort of climate, not even the best of bilateral relationships can flourish.

Free Trade in the Pacific?

One way of ensuring a more favorable environment in which the Canadian-Japanese relationship could flourish, while mov-

[7]There have been recent exceptions to do with beer, wine, and fish processing.

ing the world toward freer multilateral trade, would be to promote a free trade area in the Pacific. The ultimate aim would be to include Australasia and those of the region's newly industrializing economies that were prepared to make the necessary adjustments to join. Initially, however, it might encompass just the United States, Japan, and Canada.

Alternatively, it might make even more sense for Canada and the United States first to broaden their Free Trade Agreement to include Australia and New Zealand, which recently entered into their own Closer Economic Relationship. The timetable for the Australia-New Zealand deal, which covers trade, investment, and other matters, has recently been accelerated in view of both countries' satisfactory experience in its initial years. Although both have Labour governments, they have moved away from the protectionist and interventionist ideas of nineteenth-century socialism. They are now stressing market-directed, fiscally responsible policies in order to promote growth, arrest a relative decline in their standards of living, and make themselves more competitive. As a consequence, they have since become much more dynamic and efficient economies, and could be receptive to the idea of joining a wider, Pacific Free Trade Area.

The Canadian and U.S. governments ought to explore such a link. Even more importantly, however, they should seriously consider a similar arrangement with Japan at the same time. The five-member area would bring together countries representing close to 40 percent of world GNP and offer all of them very real political, as well as economic, gains. In addition to making the world's two biggest and richest economic powers even more dynamic, competitive, and innovative, the start of such discussions would provide a useful hedge against the possible failure of the Uruguay Round. It would also put pressure on those negotiating at the GATT to come up with a useful agreement that also dealt with nontariff barriers, agriculture, services, and intellectual property. Moreover, it would act as a stimulus to the more protectionist parts of the world to open up their own economies in a multilateral way

so as not to lose access to, and be unable to compete with, the enlarged free trade area.

In particular, talks on a Pacific Free Trade Area — especially if they are designed to lead to multilateralism and the faster elimination of protection — would put pressure on the sclerotic economies of the European Community, which still have far too many anticompetitive practices and cartels and whose labor markets are unduly rigid and unadaptable. Some of these problems may be eased by the process of liberalization, which is already under way, that aims, ironically, to make the European Community a true common market by 1992. Progress in Europe is reasonably encouraging, despite significant forces of resistance and lukewarm enthusiasm in some quarters. There is, however, a major risk that, whatever arrangement emerges in 1992, it will still be protectionist in both aim and result against the rest of the world — a "Fortress Europe." The possibility of a Pacific Free Trade Area might help to stimulate the forces of global liberalization and ensure that "1992" is an outward-looking, nonprotectionist, and modernizing arrangement.

No one should underestimate the difficulty of creating a free trade area between the United States, Canada, and Japan. Among the many knotty issues are the social and cultural differences between the two regions, the special nature of private and public tariff barriers in Japan, the question of defense production and subsidies in North America, agriculture, government procurement, investment flows, and intellectual property. The special economic relationship between Canada and the United States means their Free Trade Agreement — with its special emphasis on energy, investment, and services — is not necessarily applicable to a wider Pacific arrangement. It does show, however, that such deals can be negotiated while leaving some difficult problems aside for resolution later. In the case of the Canada-U.S. Agreement, this includes, for example, some parts of agriculture, subsidies, and final dispute resolution procedures. The lessons to be drawn from both the Canada-U.S. and Australia-New Zealand deals are that, while

daunting, determined and persistent negotiations can lead to worthwhile arrangements, and that not every issue has to be resolved immediately. Since the process would be a long one — it is improbable that any three-way arrangement could be concluded within five years — it would be wise to get started now.

Such a proposal would have attracted little support even in 1986.[8] But this situation is changing as U.S. exports continue their vigorous rise, having increased 39 percent in real terms since the fall of 1986, and at a 27 percent rate since mid-1987 — one of the fastest rates in the world. Increasing numbers of Americans are now becoming aware of how they would benefit from a more open Japanese economy as well as from the freer access already negotiated with their biggest customer, Canada.

Nevertheless, there will be major political difficulties on the U.S. side. Uncompetitive industries, subsidized farmers, overprotected unions, other vested interests, and extreme nationalists are just some of the groups that would oppose a Pacific arrangement. On the Japanese side, nationalists who are distrustful of any foreigners and who are against turning to the West for any reason would be strongly opposed. So would be those critics who tend to put all the blame for present difficulties on the shoulders of the United States instead of where it should be — about equally on both parties. Moreover, some of the more protected Japanese industries have the best of both worlds under present arrangements: virtually free access to U.S. markets without great U.S. competition in the Japanese home market. Finally, Japanese agriculture can be counted on to trot out all the old arguments about the special nature of Japan and the Japanese and the importance of filling Japanese stomachs with Japanese wheat and rice.

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[8]The U.S. Ambassador to Japan (former U.S. Senator from Montana) Mike Mansfield has been urging a United States-Japan free trade deal for many years. His foresight and wisdom is at last being rewarded through growing public discussion of the idea.

One of the important issues that would have to be resolved in any such free trade talks is that of the newly industrializing countries of the Pacific, including China, Hong Kong, South Korea, Singapore, Taiwan, and Thailand. While it is dangerous to lump these countries together, they are an increasingly important group. By 1990, for example, they will collectively export more manufactured goods than will Japan. Moreover, they increasingly compete with the United States for Japan's attention. Because of Japan's proximity, its growing trade with them, its success, its "Asianess," and other factors, those countries look to Japan for leadership, despite hostilities arising from the Second World War and current Japanese trade practices. Japan thus would have to satisfy itself and those countries that a free trade deal with the United States made satisfactory arrangements for them. One approach would be to include those countries. Another would be for Japan itself to offer them more than enough of its domestic market to compensate for any losses they might suffer in U.S. markets as a result of Japan's enhanced competitiveness there. This would be a difficult, but by no means impossible, issue to resolve.

Japan now admits that a free trade deal with the United States is "certainly worth considering," according to a senior official of MITI. Continuing friction in the *nichibei* relationship between Japan and the United States led to the idea's surfacing at the time of the January 1988 talks between President Reagan and Prime Minister Takeshita. The idea is now under concrete study at both MITI and the Ministry of Foreign Affairs, and doubtless in the private sector as well. The U.S. government has begun to look at the issue, and foundations and research institutes are beginning to give the question a careful examination. The political and technical problems would be formidable, especially in dealing with the intricate network of nontariff barriers that is so invisibly interwoven into the fabric of Japanese society. (In general, U.S. nontariff barriers are more visible, if no less embedded.) Still, the idea of a United States-Japan free trade area is now more than just

a gleam in somebody's eye. It may yet become a reality, although only after a long conception period.

In addition to being a hedge against world relapse into protectionism, such an arrangement could lead to a leapfrogging of some of the special difficulties that bedevil, or that potentially do so, relations between Japan and the United States A fresh approach to antidumping problems, similar to the unique dispute settlement mechanism pioneered by the Canada-U.S. Agreement for example, could make the exercise very worthwhile. So too could mechanisms designed to defuse potential hostility toward Japanese investment in the United States. Japanese investment abroad is now over U.S.$1 trillion on a gross basis — about U.S.$250 billion net — and will grow rapidly in the years ahead, despite reduced Japanese surpluses on current account. It must not be allowed to become an irritant to trade, capital, and other relationships between them. Moreover, as the two countries at the forefront of revolutions in information, communications, and high technology, Japan and the United States need to apply some policy creativity to solving the problems of rapid change that these revolutions are causing. An imaginative look at ways to solve the two countries' bilateral problems — not only of trade, investment, technology, and economic development, but of world security and leadership as well — could pay enormous dividends.

Canada has a particular interest in any United States-Japan arrangement. Its exclusion from such an agreement could be harmful not only to its interests in the fast-growing Japanese and related markets in the Pacific region, but also to its prospects in the United States market. This is because Japanese imports then would become duty free, and thus more competitive, in the United States, and Japan might be seen as just as reliable a source of supply as Canada. A three-way deal, including Canada, would better protect Canada's direct interests. It would also promote Canada's wider goals, since Canadian involvement doubtless would encourage the parties to look outward, to be as broad and unrestrictive as possible

in their approach, and to keep the ultimate objective of a multilateral arrangement very much to the fore.

Canada could also draw on its own experience in bringing about a free trade arrangement with the United States to promote this wider Pacific arrangement. It is clear that the parties are not yet ready, nor is the situation ripe, for formal talks. In Canada, the ground was prepared and many of the issues analyzed and aired by a Royal Commission and a seminal analysis by the C.D. Howe Institute.[9] Perhaps in addition to the internal government and private studies going on in the United States and Japan, a distinguished commission of Americans, Japanese, and Canadians might study the issues and prepare the ground by producing a readable and objective report together with the related, in-depth research analysis.

A wider free trade arrangement including both Japan and the United States, and in which Canada might play a special role as facilitator and mediator, would also promote improved political cooperation between the world's two major economic powers, and make it easier for Japan to assume its share of world leadership. The country's history, its relatively remote location, its attitudes toward others, and its constitutional limitations on military outlays make it unlikely that Japan will emerge as the world's dominant leader — although it could become the largest economy in the world in the early twenty-first century, depending on its growth rate relative to that of the United States.

The United States, on the other hand, has the adaptability, innovativeness, self-confidence, and technological prowess — along with the political and military strength — to justify a continuing preeminent position in the world. Despite its becoming a net foreign borrower, it thus may prove to be the first major debtor ever to maintain its position as a global leader. It is likely, however, to have to share that leadership and

[9]Canada, Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report*, 3 v. (Ottawa: Supply and Services Canada, 1985); and Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation 27 (Toronto: C.D. Howe Institute, 1985).

power with Japan in some new form of cooperative, virtually condominium, arrangement.

Japan's new economic strength, growing confidence, and more internationalized society will push it into this shared role, and not just in economic affairs. The economic arena, however, increasingly will call for Japanese leadership in such international organizations as the GATT, the International Monetary Fund, and the World Bank. Japan will also be expected to play a more significant role as the leading international investor in both debt and equity, and in international aid, technology transfer, and research and development consortia. A Pacific arrangement could be a vital forum for the exercise of Japan's increasing responsibility and creative leadership in world affairs.

Conclusions

During the past two years, Japan once again has proven its enormous capacity to adjust to difficulties and change. The reorientation of its economy toward domestic-led growth is proceeding with more success than even the optimists had dared to hope. The restructuring of some of its problem sectors at last has begun. Its society is becoming increasingly internationalized and open to the flow of ideas, investment, and trade. Too many barriers to trade remain, however, and there are still too many shortsighted policies that protect vested interests or exploit a near-term advantage but do grave harm to Japan's longer-term credibility and reputation. But even these are beginning to change under the combined weight of outside criticism, fear of global isolation, shifting political power at home, and a more farsighted view of the responsibilities of leadership.

Japan's rapid growth will create many opportunities for Canada, particularly if Canada capitalizes on its new-found confidence and greater interest in exports. A much stronger trading relationship should develop, which will increase the percentage of Canada's foreign commerce conducted with

Japan. There is also enormous potential for investment and for joint ventures promoting the two-way spread of innovation, research, and technology. Resources, especially in more processed form, will still be an important element in Canadian exports, as will food and agricultural products. An increasing proportion of the exchanges between the two countries, however, will involve goods and services that are knowledge-intensive and that depend on relatively large amounts of brainpower, technological skills, and management input.

Whether or not it is inside a wider Pacific arrangement, Canada can be a valuable friend to Japan, as well as an adviser and a mediator in the ongoing differences that are bound to arise in the U.S.-Japanese relationship. Although the first responsibility of Canada and Japan is to have sensible and constructive domestic economic policies, the two countries together can use their influence, especially with the United States, to ensure that world macroeconomic policy is also sensible and balanced.

A framework of sustainable and reasonably reliable growth is also a crucial precondition for successful microeconomic policies. These policies have been the key to much of Japan's success. Contrary to the cherished beliefs of many, they have been market oriented and aimed at reinforcing the disciplines of competition to promote needed adjustment and change. Despite the profound cultural, political, and social differences between the two countries, each has much to learn from the other. From Japan, Canada can learn about cooperation, professionalism in doing one's job, the application of technology to production problems, and the importance of taking a long-term view. From Canada, Japan can learn about innovation, the promotion of diversity, the development of true multinational companies, and understanding the United States, just to take a few examples.

In a zero-inflation world, to which the increasing role of the rapidly growing, highly productive Pacific Rim economies may

well lead,[10] these matters of microeconomic management and competitiveness take on increasing importance. Fortunately, a society does not have to be homogeneous for its various sectors to work effectively together — Japan is not, despite assertions to the contrary. Nor do the rights of any single group need to be sacrificed in order for a society to be competitive. And certainly, management does not have to be shortsighted to do well for its shareholders in the longer term, as any investor in Japanese shares can attest.[11]

In recent years, Canadians have shown increasing confidence, a greater readiness to innovate, and an outward-looking perspective. Coupled with high educational and skill levels, this has given Canada an increasing advantage in resources, certain segments of manufacturing, and technologically advanced goods and services. If this country can harness these strengths to a growing sense of discipline and competitiveness, its relationships with Japan, and indeed with the other Pacific Rim countries, should be the source of even more vigorous growth, diversity, and wealth for Canadian society in the years ahead.

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[10]The Pacific Rim will be the locale of over half the world's GNP and manufacturing activity by 2000.

[11]Some analysts worry that the very success of the Japanese stock market, which now has a price-earnings ratio of over 50 and an earnings yield of just under 0.5 percent, has made it vulnerable to a major correction. However, when account is taken of conservative Japanese financial reporting and the large holdings of the typical Japanese company in property and shares at very low historic costs, the risk is considerably reduced, although by no means eliminated.

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H. Anthony Hampson

H. Anthony Hampson is Chairman of the C.D. Howe Institute Policy Analysis Committee. He served with the Canada Development Corporation as Chairman, President, and its first Chief Executive Officer from 1971 to mid-1987, when he retired to pursue other interests in business and public policy analysis. Earlier in his career, Mr. Hampson worked in both the private and public sectors, including service with the Department of Finance in Ottawa, the Gordon Commission on Canada's Economic Prospects, and as Secretary to the Royal Commission on Banking and Finance.

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